



September 29, 2011

Honourable Mary Creagh MP
c/o Andrew Pakes
House of Commons
London
SW1A 0AA
United Kingdom

Dear Ms. Creagh :

Better Markets, Inc.¹ appreciates the opportunity to comment on the proposed Regulation of the European Parliament and of the Council on Markets in Financial Instruments (the “Regulation”) and Directive of the European Parliament and of the Council (the “Directive”). We hope that our observations and suggestions are helpful to you in the development of these important documents.

SUMMARY OF COMMENTS

Certain General Principles

There are two central principles which are the focus of many of the provisions of the Regulation and Directive: markets need to be **Level Playing Fields**, and rules governing behavior of market participants must be based on **the concept of regulatory Proportionality**.

A Level Playing Field requires open and fair access to all market infrastructure and activity. Development of a Level Playing Field is a fundamental goal of MiFID review and the Commission’s impact assessment pursuant to its “Better Regulation” policy, as described in the Regulation preamble (at page 2).

Proportionality means that the public’s interest in a safe marketplace that fulfills its core purposes must be balanced against the restrictiveness of regulations governing activities and behaviors. It is harmonious with the fundamental principle of Proportionality in Article 5 of the Treaty on European Union. The concept is embedded in the discussion of many aspects of the regulation and is articulated in the Regulation preamble (at page 4):

The proposal... take[s] into account the right balance of public interest at stake and the cost-efficiency of the measure. The requirements imposed on the different parties have been carefully calibrated. In particular, the need to balance investor protection, efficiency of the markets and costs for the industry has been transversal in laying out these requirements. For instance, regarding the new transparency rules that could be applied to bonds and derivatives markets, the revision advocates for a

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

carefully calibrated regime that will take into consideration the specificities of each asset class and possibly each type of derivatives.

Level Playing Field

The Regulation and Directive must address the many ways, both direct and indirect, that derivatives market structures can be used to advantage classes of market participants at the expense of others. Concentration of market power has been an enduring feature of derivatives markets, and contributed heavily to the financial crisis of 2008. The present infrastructure of the derivatives marketplace depends on volume-based fees for revenue. In such a concentrated market, institutions with market power can direct trading flows to infrastructure providers, which they thereby greatly influence, with obvious negative consequences for a competitive and transparent marketplace.

Ultimately, how transactions are executed and cleared and how trade data is captured and aggregated allows powerful trading institutions to distort the essential agent/principal relationships with customers, both directly and by disguising the exercise of market power. Lack of transparency during the path of a transaction, from the initial order through execution, clearing and reporting, adversely affects the market as a whole. When this occurs, the fair and open agent/principal relationship so necessary to the interactions between financial institutions and customers is trumped by conflicts of interest.

To change these historic and ongoing failures in the derivatives markets, the Regulation and Directive must be much more forceful and specific in certain areas. This is particularly important in the articles relating to the infrastructure of the markets. **Market access must be fair and open so that financial agent influence is eliminated and/or substantially reduced.** Specifically:

- **Inducements for market flow must be eliminated.** These inducements can be in the direct payment for volume. They can also be in the form of discounts for services, revenue or profit shares, equity interests and targeted structural influence on decisions which lead to trading and customer-related advantages.
- **Access to information on the markets, both pre-trade and post-trade, must be open and equitable.** This includes both **quantity and quality** of data as well as the **speed with which data is made available**. Market advantages are more and more a function of the speed with which orders can be placed and cancelled and the asymmetrical acquisition of information needed to inform trading strategies. Time is measured in tiny fractions of seconds and decisions are automated using algorithms because direct human intervention is too slow. Asymmetry of information can both trigger disruptions and amplify their effects. Select disclosure of any kind of customer order-tracking information must be eliminated, whether customer-specific or anonymous. Regulation must establish the principles required to accomplish these standards if markets in the future are to be truly open and transparent.

Proportionality

In addition, the principle of Proportionality is a central tenet to the Regulation and Directive. However, the Regulation and Directive provide insufficient guidance for the

application of this principle. **Proportionality requires that rules governing trading activities** must be based on an assessment of **the value of the trading behavior** in relation to the potential harm that it may cause. Proportionality must focus the assessment of benefit and harm on the core purposes of markets. Derivatives and capital markets do not only exist so that financial institutions can profit from a given trading strategy or technique. If a strategy or technique involves material risks to the marketplace, these systemic costs must also be a focus of regulation, rather than examining only the benefit of likely profits to financial intermediaries. The conflation of profitability and benefits to the marketplace, without a proportional focus on systemic costs, was a central cause of the failure of regulation to deal with potential systemic risk that was clearly illustrated by the recent financial crisis.

The Regulation and Directive must recognize the core purposes of markets so that regulatory authorities can properly frame the issue of Proportionality. For example, derivatives markets serve the related purposes of facilitating risk mitigation and price discovery for the business sector. To the extent a strategy or technique serves these purposes it has value; its profitability may be important to a trader, but not necessarily to the interests of the public.

Additional liquidity is the benefit most often cited in support of trading strategies and techniques. On this issue, the concepts of volume and liquidity are often confused and must be carefully analyzed as specific rules are developed. For example, high frequency trading based on algorithms undoubtedly increases volume. But, if the automated system withdraws liquidity from the market when liquidity is most needed (for example, when prices move beyond thresholds in reaction to unanticipated, non-fundamental forces), the practice cannot be said to provide a value to the market. The constant refrain from financial intermediaries that benefit from greater transaction volume that more “liquidity” is always necessary should be closely examined by regulators. Not all “liquidity” is alike, and many times new speculative volumes can actually be counterproductive to market structure. It is clear that the concept of proportionally balanced regulation can directly apply to the idea of liquidity.

As another case in point, commodity index fund trading activity adds speculative volume. However, activity related to investment inflows and outflows and the rolling of contracts into longer duration contracts is completely unrelated to fundamental information based on market prices and volumes. Hedgers in commodities markets do not rely on commodity index fund trading to find liquidity for their transactions. This mechanical commodity index market activity neither provides timely access to counterparties willing to trade nor any reliable view of fundamentals-based pricing.

Proportionality means that the threshold for risk of market distortion and the potential benefit to the market are related and must be balanced against the interests of the public. This must be reflected in relation to many aspects of the Regulation and Directive, but particularly in Title VII of the Regulation, Supervision of Products and Positions.

Specific comments are set forth below. These comments address these general principles as well as detailed issues related to the Regulation and Directive.

Specific Comments

1. Scope of Transparency Rules (Regulation, Preamble, Paragraph 8, Articles 6 and 11)

It is stated that only those financial instruments traded purely over-the-counter (“OTC”) which are deemed particularly illiquid or are bespoke in their design would be outside the scope of the transparency obligations.

This scope is too narrow, falling short of the transparency required for a Level Playing Field. Transaction data on illiquid derivatives can and should be reported. The fact that a derivative may not trade often does not mean that its price is unrelated to other, more liquid contracts. The immediate post-trade information is informative and enhances price transparency. And the ongoing existence of the position has risk implications. Illiquid positions can still be valued with reference to associated listed price-related contracts, even though the precision of the measurement may be somewhat lower.

Detailed guidance as to the meaning of “bespoke” and similar characterizations is required. In the real world, complex transactions are largely just composites of simpler transactions. If they could not be disaggregated and valued, how would financial institutions keep track of their risk? Reporting entities must be required to disaggregate complex transactions (linking the component risk modules by transaction tags) **just as they routinely do when recording data into their risk databases.**

2. Waivers from Transparency Requirements (Regulation, Article 4)

Competent authorities are permitted to grant waivers from post-trade transparency for derivatives based on the type and size of orders and method of trading.

The expressed standards – type and size of orders – are inappropriate. Waivers are justified only if the orders are sufficiently large to disruptively affect market price (often referred to as “block trades”). The relevant standard is the potential disruptive effect on market prices. Size is a relevant consideration, but it is the result of the analysis not its focus. Every market for every product could conceivably have different results as to size. For example, a large trade in the crude oil market may have little effect on prices. But the same sized trade in the electricity market would be extremely disruptive.

If the standards are imprecise or misdirected, the rules will be exploited and the Playing Field will not be Level. A formula-based approach which can be used in different markets is preferable. As an example, the CFTC has proposed a two-part test: transaction repositories would examine historic data for a market and set block trade threshold sizes so that they are larger than 95 percent of historic trades; and the mean, median and mode would be calculated and a multiplier (5) applied to the largest of the three to create a second threshold. The larger of the thresholds would apply. The approach is designed to capture markets with different liquidity profiles in which trade size varies and those in which they do not.²

² CFTC, Proposed Rule, Real Time Reporting of Swap Data, 75 FR 76140 at pages 76161-2

3. Data Reporting Requirements (Regulation, Articles 6 and 12)

The data requirements are explicitly designed solely for the purpose of enhancing transparency.

This is inadequate. The G20 states that the purposes for derivatives trade data capture and aggregation: “to improve transparency in the derivatives markets, **mitigate systemic risk, and protect against market abuse.**” (Leaders' Statement at 9, Pittsburgh Summit, 25 September 2009)[Emphasis added]. The August 2011 report by the Committee on Payment and Settlement System and the International Organization of Securities Commissions on OTC Data Reporting and Aggregation Requirements interprets the systemic risk element as requiring data which supports monitoring of counterparty risk exposures on a portfolio basis and emphasizes the need to monitor for market abuse. The data reporting requirements are silent on this and suggest that it is not required when it is expressly mandated.

4. Non-Discriminatory Access to Clearing Entities, Trade Execution Venues and Benchmarks (Regulation, Articles 26, 27 and 28; Directive, Preamble)

Open access is provided for generally.

However, preferential access arising from conflicts of interest is a far more complex issue than is addressed in the Regulation and Directive. The conflicts which lead to preferential access must be addressed if the Playing Field is to be Level. Preferential access to information flows, both in terms of time and the quality of data, must be prohibited. Furthermore, non-discriminatory access does not preclude market participants from striking preferential deals. The transfer of value in exchange for volume must be prohibited. Typically, this involves payments, discounts, revenue or profit shares, and equity or carried interests. The result is that less powerful market participants bear the full cost of the market infrastructure and they have no other choice. The access may be non-discriminatory, but it is far from equitable. If this is not done, there will never be a Level Playing Field and an oligopoly will control the critical infrastructure.

5. ESMA Power to Prohibit Disruptive Transactions and Activities (Regulation, Article 29; Directive, Preamble)

ESMA is empowered to prohibit financial instruments or financial activity if they pose a threat to orderly markets or the stability of the financial system.

The standards are subject to an interpretation which is too narrow. Trading strategies and methodologies must be expressly included. High frequency and algorithmic trading constitutes a huge challenge to regulatory authorities. Their tactics are largely adaptations of practices which have long been discredited as improper. However, regulatory authorities lag behind the innovation curve and the new tactics have persisted and proliferated.

Specifically, the question whether a strategy or methodology adds material efficiency in terms of actual and meaningful liquidity (contrasted with the mere increased volume created by HFT which disappears automatically at times of market

stress when liquidity is needed) must be added to the criteria for the exercise of authority by ESMA. The criteria must be complete if the regulation is to be proportionally balanced and effective.

6. Position Management Authority of ESMA and Position Measurement (Regulation, Article 33; Directive, Article 47B)

ESMA is empowered to limit or reduce positions in a commodity, if needed, to address a threat to the orderly functioning and integrity of financial markets.

The threshold for taking action is too narrowly drafted for a proportionally balanced regulatory result. Price discovery is a central purpose of commodities markets. This relates to prices immediately applied to spot markets and to the entire price curve which influences expectations of price increases and decreases over time. A market can appear to be operating like a well-oiled machine, except that the price curve generated by the trading is reflective of influences unrelated to fundamental supply and demand.

In addition, the purpose and the functional value of the type of positions limited must be a relevant consideration. Hedging activity represents a core purpose of commodities markets. But non-hedging activity, or speculation, is only required to facilitate hedging up to a calculable percentage of the entire market. Speculation in excess of that amount is excessive and may be damaging to the market's core purposes.

Moreover, certain types of speculation may be structurally impeded from providing liquidity to hedgers. Speculation related to commodity index funds and ETFs fall into this category. This trading occurs when the structure of the funds requires it, not when liquidity is demanded.

Position management powers must be exercised based on a balancing of the benefits to the public's interests (expressed as the efficient fulfillment of the core purposes of the commodities markets: price discovery and hedging) against the potential for damage to those interests. The Regulation and Directive must reflect this.

Guidance on and standards for position measurement are required. The financial services industry uniformly uses techniques which break down portfolios in accordance with risks and value instruments using related, more available prices. These techniques must be mandated in the directive. Furthermore, detailed rules addressing the aggregation of positions in the control entity in a complex organization is essential. Regardless of how the position is expressed by an entity (what venue and whether listed or OTC), positions should be aggregated into equivalent positions. That way, regulators are not mandating the choice of venue or structure, but limiting the position to an aggregate level across venues and/or structures. Positions should not be allocated to entities based on a corporate organization chart, but rather in accordance with a matrix of principles such as who controls the decisions, where the profit ultimately resides, and who is at risk for credit losses. In other words, all positions should be viewed at the control entity level by regulators.

7. Duties to Customers (Directive, Preamble, Article 22)

Duties of dealers to customers are addressed in the Directive.

However, the essential requirement that the agent/principal relationship be free from conflicts of interest is insufficiently addressed. It is abundantly clear that the computational complexity inherent in derivatives impedes fundamental understanding of the contracts by buyers (and sometimes sellers). Special classes of customers must be provided extraordinary protection. However, the concept of the “sophisticated” customer is inadequate in the derivatives market.

Detailed disclosure of risks and costs to all must be required. Risks include the potential for price moves and the illiquidity of the instrument, as well as counterparty credit exposures. As a result, scenario analysis must be provided to customers. Costs include the cost embedded in a derivative if a financial institution agrees to forego margin collateral, a credit exposure which is always charged for, but usually in an invisible and undisclosed price mark-up. These costs must be separately and accurately disclosed.

Alternatives which are simpler and less risky because they are more liquid must be disclosed. The dealer can make more from a complex instrument but the customer may be better off with a simpler solution, even if the hedge is somewhat less precise.

Proposal for a Regulation of the European Parliament and of the Council on Markets in Financial Instruments

Certain General Principles

There are two central principles which are the focus of many of the provisions of the Regulation: markets need to be **Level Playing Fields** and rules governing behavior of market participants must be based on **the concept of Proportionality**. A *Level Playing Field* requires open and fair access to all market infrastructure and activity. Development of a Level Playing Field is a fundamental goal of MiFID review and the Commission's impact assessment pursuant to its "Better Regulation" policy, as described in the preamble (Regulation, page 2).

Proportionality means that the public's interest in a safe marketplace that fulfills its core purposes must be balanced against the restrictiveness of regulations governing activities and behaviors. The concept is embedded in the discussion of many aspects of the regulation and is articulated in the preamble (Regulation, page 4):

The proposal... take[s] into account the right balance of public interest at stake and the cost-efficiency of the measure. The requirements imposed on the different parties have been carefully calibrated. In particular, the need to balance investor protection, efficiency of the markets and costs for the industry has been transversal in laying out these requirements. For instance, regarding the new transparency rules that could be applied to bonds and derivatives markets, the revision advocates for a carefully calibrated regime that will take into consideration the specificities of each asset class and possibly each type of derivatives.

Level Playing Field

The Regulation must address the many ways, both direct and indirect, that derivatives market structures can be used to advantage classes of market participants at the expense of others. Extreme concentration of market power (which means anyone's test for oligopoly power) has been an enduring defect of derivatives markets,³ and contributed heavily to the financial crisis of 2008. The present infrastructure of the derivatives marketplace depends on volume-based fees for revenue. In such a concentrated market, institutions with market power can direct trading flows to infrastructure providers, which they thereby greatly influence, with obvious negative consequences for a competitive and transparent marketplace. Better Markets has detailed the direct and indirect means and methods of market control and power in these markets in comment letters filed with the U.S. Commodity Futures Trading Commission ("CFTC").⁴

³ OCC's Quarterly Report on Bank Trading and Derivatives Transactions, Fourth Quarter 2009, available at <http://www.occ.gov/news-issuances/news-releases/2010/nr-occ-2010-33a.pdf>

⁴ See, e.g., Better Markets Comment Letter to CFTC, Proposed Rule Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets; and Swap Execution Facilities, November 17, 2010, available at: <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26475&SearchText=better%20market;>

Ultimately, how transactions are executed and cleared and how trade data is captured and aggregated could allow powerful trading institutions to distort the essential agent/principal relationships with customers, both directly and by disguising the exercise of market power. Lack of transparency during the path of a transaction, from the initial order through execution, clearing and reporting, adversely affects the market as a whole. When this occurs, the fair and open agent/principal relationship so necessary to the interactions between financial institutions and customers is trumped by conflicts of interest.

To change these historic and ongoing failures in the derivatives markets, the Regulation must be much more forceful and specific in certain areas. This is particularly important in the articles relating to the infrastructure of the markets. **Market access must be fair and open so that financial agent influence reinforced by concentration of market power is eliminated and/or substantially reduced.** Specifically:

- **Inducements for market order flow must be eliminated.** These inducements can be in the direct payment for volume, or they can also be in the form of discounts for services, revenue or profit shares, equity interests and targeted structural influence on decisions which lead to trading and customer-related advantages.
- **Access to information on the markets, both pre-trade and post-trade, must be open and equitable.** This includes both **quantity and quality** of data as well as the **speed with which data is made available**. Market advantages are more and more a function of the speed by which orders can be placed and cancelled and the asymmetrical acquisition of information needed to inform trading strategies. Time is now measured in tiny fractions of seconds and decisions are automated using algorithms because direct human intervention is too slow. Asymmetry of information can both trigger disruptions and amplify their effects. Select disclosure of any kind of customer order-tracking information must be eliminated, whether customer-specific, anonymous, or on an aggregated basis. It is important to note that any disclosure of customer information, even if the customer is not identified, is valuable order flow information. This is especially true when the information is aggregated together and then promulgated in an asymmetric manner (for instance, sold to the highest bidder). Regulation must establish the principles required to accomplish these standards if markets in the future are to be truly open and transparent.

Proportionality

In addition, the principle of Proportionality is a central tenet to the Regulation. However, the Regulation provides insufficient guidance for the application of this principle.

Proportionality requires that rules governing trading activities must be based on an assessment of **the value of the trading behavior** in relation to the potential harm that it **may** cause. Proportionality must focus the assessment of benefit and harm on the core purposes of markets. Derivatives and capital markets do not only exist so that financial institutions can profit from a given trading strategy or technique. If a strategy or technique may involve material risks

Better Markets Comment Letter to CFTC, Proposed Rule Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets; and Swap Execution Facilities; Additional requirements Regarding the Mitigation of Conflicts of Interest, March 7, 2011 *available at*:

<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31090&SearchText=better%20markets>;

Better Markets Comment Letter, Reopening and Extension of Comment Periods for Rulemaking Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, June 3, 2011, *available at*

<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=44794&SearchText=better%20markets>

to the marketplace, these systemic costs must also be a focus of regulation, rather than examining only the benefit of likely profits to financial intermediaries. The conflation of profitability with benefits to the marketplace, without a proportional focus on possible systemic costs, was a central cause of the failure of regulation to deal with potential systemic risk that was clearly illustrated by the recent financial crisis.

The Regulation must recognize the core purposes of markets so that regulatory authorities can properly frame the issue of Proportionality. For example, derivatives markets serve the related purposes of facilitating risk mitigation and price discovery for the business sector (as distinguished, in particular, from the financial sector). To the extent a strategy or technique serves these purposes it has value; its profitability may be important to a trader, but not necessarily to the interests of the public.

Additional liquidity is the benefit most often cited in support of trading strategies and techniques. **On this issue, the concepts of volume and liquidity are often confused** and must be carefully analyzed as specific rules are developed. For example, high frequency trading based on algorithms undoubtedly increases volume. But, if the automated system withdraws liquidity from the market when liquidity is most needed (for example, when prices move beyond thresholds in reaction to unanticipated, non-fundamental forces), the practice cannot be said to provide a value to the market. The constant refrain from financial intermediaries that profit tremendously from greater transaction volume that more “liquidity” is always necessary should be critically examined by regulators. Not all “liquidity” is alike, and many times new speculative volumes can actually be *counterproductive* to market structure. It is clear that the concept of proportionally balanced regulation can directly apply to the idea of liquidity.

As another case in point, commodity index fund trading activity adds speculative volume. However, activity related to investment inflows and outflows and the rolling of contracts into longer duration contracts is completely unrelated to fundamental information-based market prices and volumes. Hedgers in commodities markets do not rely on commodity index fund trading to find liquidity for their transactions (after all, there were no complaints of a shortage of liquidity in these markets more than 10 years ago, which was prior to the exponential increase in commodity index type investment pools). In fact, this mechanical commodity index market activity neither provides timely access to counterparties willing to trade nor any reliable view of fundamentals-based pricing.

Proportionality means that the threshold for risk of market distortion and the potential benefit to the market are related and must be considered in balancing against the interests of the public. This concept must be reflected in relation to many aspects of the Regulation, but particularly in Title VII, Supervision of Products and Positions.

Specific comments are set forth below. These comments address these general principles, as well as detailed issues related to the Regulation.

Preamble

Paragraph 8

It is stated that only those financial instruments traded purely OTC which are deemed particularly illiquid or are bespoke in their design would be outside the scope of the transparency obligations.

This formulation should be changed in two respects. First, post-trade transparency should not be limited by the liquidity of the transactions. Data on illiquid transactions is clearly useful to both the public and regulatory authorities. Second, the concept of “bespoke” must be more fully developed. For example, a transaction that substantively consists of two swaps executed simultaneously should be **disaggregated** and made transparent. To do otherwise ignores the reality of the transaction and provides an easy avenue for avoidance of disclosure.⁵

Paragraph 12

As referenced in the last two sentences in the prior comment, disaggregation must be required so that commercially known components of compound transactions are reported separately. *This is how financial institutions worldwide routinely record such transactions in their data capture and risk tracking systems.*

In a recent CFTC roundtable on unique identifiers and other topics, one of the industry’s representatives described how composite derivatives are broken down into more conventional units or legs for purposes of recording and monitoring a market participant’s portfolio.⁶ His analysis of the need for and routine practice of disaggregation is correct. Often dealers structure derivatives which are composites of straightforward swaps. They may bridge asset classes or be composed of different products within asset classes.

Sometimes they are characterized as “bespoke” or customized transactions, suggesting impenetrable complexity. However, the claimed complexity is almost always created and artificial.

Eliminating this artificially created complexity requires nothing more than to follow the industry practice as discussed by several participants in the roundtable: disaggregation by the reporting entities of composite transactions into legs based on risk, rather than limiting the data by the documented form of the transaction.

The following example may be helpful. Power Plant Owner A enters into a swap with Dealer B to guarantee the difference between the price of natural gas and the price of power at given delivery points for gas and power serving the plant. It is used by Power Plant Owner A to fix the difference between the cost of fuel expected to be consumed at its plant in eastern Maryland and the electricity output expected to be sold into the grid. Power Plant Owner A expects to consume 329,333 mmbtu of gas and generate 34,667 mwh of electricity for sale. The difference in cost and price guaranteed by the swap is \$486,573, which is the fixed amount paid by Dealer B. Plant Owner A will pay the actual difference in prices on the notional quantities.

In reality, the transaction example is nothing more than a combination of the following two swaps:

- A natural gas swap at the delivery point (Tetco M3) for the period with a quantity equal to the quantity of assumed consumption fixing the price at \$4.36/mmbtu; and

⁵ These issues are discussed at length in Better Markets Comment Letter to CFTC, Proposed Rule Real Time Reporting of Swap Data, February 7, 2011, *available at*

<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27631&SearchText=better%20markets>

⁶ CFTC Roundtable, January 28, 2011. Swap Data Recordkeeping and Reporting, Comments of Adam Litke commencing on Transcript page 187, *available at*

http://cftc.gov/ucm/groups/public/@swaps/documents/dsubmission/dfsubmission17_012811-transcri.pdf

- A power swap at the delivery point (Pepco) with a quantity equal to the quantity of assumed power sold fixing the price at \$55.47/mwh.

The industry participants in the January 28 roundtable hosted by the CFTC indicated that only a tiny percentage of all transactions require recordation beyond the capacity of their trade data capture systems. **This means that almost all of the transactions which are characterized as “bespoke” are simply composites of understandable derivatives risks handled by disaggregation as described by those industry representatives.** This makes sense: traders deal in derivatives risks and it would be concerning (to say the least) if the individual risks in a given transaction could not be described and measured with some degree of confidence. **Private entities combining risks in a single instrument (often for the sole purpose of maximizing their profits) must not be allowed to obstruct reporting of meaningful information, which those private entities have readily available and use as a routine matter.**

This type of transaction might meet specific needs of a customer. But why not simply enter into multiple swaps which are each more transparent than the composite transaction? Convenience is one answer, but it is not very persuasive since documentation is almost exclusively electronic. There are other more nefarious possibilities. A composite swap obscures the market price of each of the component swap units. It may even allow the dealer and the customer to record the separate composite risks at different prices. It may also simply have the marketing appeal of an apparently clever solution to a seemingly complicated problem.

Regardless of the reason(s), the market data under the Regulation must be at least as useful and decipherable as the data available to dealers themselves as they measure and monitor their own positions. The reporting entity must assign a market-based price to the components of a composite swap, whether it is mixed or multi-asset (composed of multiple assets classes). Likewise, swaps within asset classes but involving different products or temporal terms must be assigned component prices as well.

Paragraph 19

In describing mandatory execution, a standard is suggested that infers that transactions subject to the mandate must be available on a “range” of trading venues. Transactions which are available on a single trading venue should also be subject to mandatory trading if certain conditions are met. For instance, if the trading activity is substantial the condition should be met, even if all trading activity takes place on a single venue. Of course, this means that the portions of the Regulation dealing with Level Playing Fields in respect of trading venues would be even more important.

Article 4

Paragraph 3

Competent authorities are permitted to grant waivers from post-trade transparency for derivatives based on the type and size of orders and method of trading. Waivers are justified only if the orders are sufficiently large to materially affect market price (often referred to as “block trades”). This method of trading is not a determinant of the applicability of transparency. Trading platforms will conform to market needs and transparency compliance is one of those needs. *If such specificity is not provided, transparency of the markets could be substantially less than that envisioned by the G20.*

Under the proposed rules on swap execution facilities promulgated by the CFTC, similar issues are confronted in the context of requests for proposals. The Better Markets comment letter relating to such proposed rules points out that the central issue is the block trade concept.⁷ The critical issue actually is the potential disruption of prices, not the size or number of requestees.⁸ Block trades which, in the context of the specific market, could disrupt pricing must be the **only** basis for a waiver. The standard for waivers must focus on this issue of central importance, rather than size or method of trading.

Article 6

Paragraph 1

This provision requires public disclosure of the details of transactions executed on regulated markets, MTFs and OTFs. The purposes for disclosure are stated in paragraph 24 of the preamble:

The details of all transactions in financial instruments should be reported to competent authorities to enable them to detect and investigate potential cases of market abuse, to monitor the fair and orderly functioning of markets, as well as the activities of investment firms.

This should be contrasted with the purposes identified by the G20 for derivatives trade data capture and aggregation: “to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.”⁹ Fundamentally, it omits the mitigation of systemic risk. Thus, while the Regulation addresses the issue of fair and orderly functioning of markets, issues related to systemic risk, such as monitoring of exposures, are not addressed. This illustrates the need for comprehensive and sensible aggregation of the trade data, as recommended by the consultative report discussed below.

In addition, the Regulation must provide far more detailed guidance as to the transaction data to be disclosed if it is to address certain weaknesses in the existing system:

[T]he proposed provisions will address one of the main criticisms made on the effects of the implementation of MiFID, which is data fragmentation. Besides requiring market data to be reliable, timely and available at a reasonable cost, it is crucial for investors that market data can be brought together in a way that allows efficient comparison of prices and trades across venues.¹⁰

The recently published consultative report by the Committee on Payment and Settlement System and the International Organization of Securities Commissions¹¹ (“Report”) is instructive

⁷ Better Markets Comment Letter to CFTC, Core Principles and Other Requirements for Swap Execution Facilities, March 8, 2011, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31238&SearchText=better%20markets>

⁸ *Id.*

⁹ Leaders' Statement at 9, Pittsburgh Summit, 25 September 2009; found at http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf

¹⁰ Explanatory Memorandum, page 7.

¹¹ Report on OTC Derivatives Data Reporting and Aggregation Requirements (the “Report”), August 2011, found at <http://www.bis.org/publ/cpss96.pdf>.

both on systemic risk and fragmentation of data. It is clear from that report that simple transaction data is of limited use. The central issue is how this data is aggregated.

*“Aggregation is the process of making sense of the mass of information. It is not merely compiling the trade data. It is a process of organizing it so that it fulfills the G20’s goals of assessing systemic risk, conducting market surveillance and enforcement, aiding resolution, transparency and enhanced market supervision.”*¹² It requires classification systems, as well as interconnection of classifications. In reality, derivatives market segments, such as interest rates, currencies, equities, credit and commodities, do not exist in a vacuum. Similarly, market forces are not defined by national borders.¹³ The system which includes the work of TRs must reflect the interconnectedness of markets if these goals are to be achieved.

Further, aggregation must group data which is related on a rational basis, regardless of the source of the data. “[Product] aggregation would involve the aggregation of OTC derivatives activity in one product with other OTC derivatives products sharing common risk factors.”¹⁴ In the Report, the complexity of this process is cited. However, these relationships are essential to valuation (see discussion of hedge equivalents, below) and portfolio risk calculations. The process is already well understood by financial institutions and central counterparties. Although implementation poses a challenge, the pathway is well travelled by financial intermediaries, **who already have this data at their disposal in order to hedge swaps with customers.**

Less liquid contracts involve complexities, but they do not exist in a vacuum. Their pricing is related to contracts that are exchange traded and relatively liquid. Identification of these exchange traded contracts is largely a matter of examining market practices. For instance, less liquid swap positions are often hedged with futures contracts using quantity ratios based on price-change correlations. Similarly, options are often valued based on delta-equivalent futures positions (*i.e.*, futures contracts in a notional value reflecting the differences in price move dynamics between the option and the underlying). Moreover, all OTC swaps that have any optionality associated with them will have the same “Greek” components, such as delta, theta, gamma, and vega, as part of their structure. This standardization of option type products gives ready transparency and equivalence for a myriad of option embedded swap transactions. *Perhaps most importantly, swap dealers already have this information calculated internally for every one of these types of transactions that they have consummated.* It is only necessary for regulators to **require** the reporting from financial intermediaries of these types of swaps in this standard option information format.

The trade repository or aggregator must make available these liquid equivalent contract prices as a foundation for valuation.¹⁵ Delta equivalents can then be made available for options. For swaps, basis differentials to liquid reference prices can be used as available (which may be less frequent than changes to the hedge equivalent contract), but changes to liquid reference prices cannot be ignored. **Requiring a common language based on hedge equivalents (adjusted for delta, theta, etc. as necessary) across swaps is the crucial step in achieving true regulatory transparency.**

¹² Report, pages 21-22.

¹³ “To maximise their ability to carry out their respective mandates, market regulators, central banks, prudential supervisors, overseers and resolution authorities may need a global view of OTC derivatives markets through effective and practical access to relevant data, as well as an ability to aggregate it efficiently.” Report, page 16.

¹⁴ Report, page 23.

¹⁵ In addition to delta values, other universally used functions which measure risk in order to value options, such as gamma, theta and beta, must be included in “details.”

This is not a novel proposition. In fact, if the “details” do not explicitly include these types of information, their potential usefulness is greatly diminished, or even eliminated! The regulatory standards would omit the fundamental common “language” already used by market participants to express the value of any given transaction. Reporting in delta adjusted hedge equivalents is precisely the procedure used today by financial institutions to value their positions internally. The central goal of the regulatory authorities must be to develop independent valuation processes which, at a bare minimum, employ the techniques universally used in the financial services industry.

Hedge equivalency parallels important elements of portfolio risk assessment and netting. Moreover, price movement relationships among categories of derivatives are a critical guide to the important task of developing appropriate product taxonomy of general applicability.

Paragraph 2

Competent authorities are enabled to provide for deferred publication of trade details based on transaction type or size. Deferral should be limited to block trades, as defined above. The potential disruption of market prices must be a component of the decision.

Moreover, some guidance as to the time of deferral is required. The standard should be a reasonable period of time for the block trading counterparty to substantially hedge its position, based on the trading characteristics (particularly liquidity and market depth) of the subject market. As discussed in Better Markets’ comment letter to the CFTC on the subject,¹⁶ the time frame relates to the liquidity of the market for the securities or commodities which underlie the block trades. The period should be a reasonable time required to hedge. In the interest rate market, the time period would be as brief as five minutes. Other markets would require a longer period. However, ignoring the significant differences in liquidity could substantially impair market transparency.

Article 10

Paragraph 2

Availability of firm quotes by systemic internalisers to all clients in an objective and non-discriminatory way is an important feature of the regulation. Requiring a Level Playing Field at this level will be a boon to the markets because the widely distributed executable prices will enhance transparency on an intra-day basis.

However, the last phrase in the paragraph– “on the basis of their commercial policy” – should be deleted. It is not required for the meaning and could suggest avenues for evasion of the rule.

Paragraph 14 of the preamble includes the following language, **which must be deleted** to give effect to Article 10:

It is not the intention of this Regulation to require the application of pre-trade transparency rules to transactions carried out on an OTC basis, the characteristics of which include that they are **ad-**

¹⁶ Better Markets Comment Letter to CFTC, Core Principles and Other Requirements for Swap Execution Facilities, March 8, 2011, available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31238&SearchText=better%20markets>.

hoc and irregular and are carried out with wholesale counterparties and are part of a *business relationship which is itself characterised by dealings above standard market size*, and where the deals are carried out outside the systems usually used by the firm concerned for its business as a systematic internaliser [Emphasis added].

This use of vague concepts, such as those italicized above, easily open the door for interpretations which undercut the clear meaning of Article 10.

Article 11

Paragraph 1

Limits on the post-trade disclosure of information by investment firms are established. Only transactions which are clearing-eligible, admitted to trade on a regulated market, MTF or OTF or reported to trade repositories are covered. **There should be no limitation on the transactions which must be disclosed.** Ultimately, the non-disclosure of such a transaction, or a series of such transactions, could have substantial negative consequences for the market or the regulatory authorities.

Article 12

Section 1

The obligation to publish volume and price information is limited to transactions which are clearing-eligible or are admitted to trading on a regulated market, MTF or OTF. These publication requirements must be consistent with the purposes set out by the G20, as described above in relation to Article 6. **If volume and price information are not available for strictly bi-lateral transactions, the complete picture of the market will not be available.** Indeed, important information about evolution of the trading in a specific contract so that central counterparties and execution facilities can determine if such contracts should be cleared or listed will not be available.

The systemic risk of OTC trading was recently, and once more, brought to the public's attention as more than \$2.3 billion of losses at UBS were successfully hidden for many months by a synthetic Exchange Traded Fund trader.¹⁷ The irony of a trader of a synthetic instrument creating very real (and massive) losses in a shadow OTC market is inescapable. But the fact that the losses could go undetected for so long was deeply concerning rather than ironic. With central data reporting, including counterparty identification, traders will be hard-pressed to deceive internal systems into believing illusory transactions actually exist.

Article 13

Section 4

Investment firms are required to report details of transactions in financial instruments to competent authorities by the close of business the following day. **This is clearly inadequate.** Modern system capabilities enable this to be a far shorter time period for data that does not require extensive manual compilation and other specialized procedures. A two-day period may

¹⁷ A. Peaple, "UBS Rightly Puts ETFs in Spotlight" Wall Street Journal, September 17, 2011, *available at* <http://online.wsj.com/article/SB10001424053111904060604576574684093668462.html>

be reasonable for some special types of data, but is definitely not necessary for the basic transaction data covered by Article 13. In fact, this provision should establish the principle that each category of data must be available as soon as it is technologically practicable after the necessary manual recordation of that data, but in no event later than the close of the same business day following the event.

Section 6

This section deals with the types of data to be reported to competent authorities with respect to financial instruments. Please see the comments on Article 6, paragraph 1, which are applicable to this Section 6 as well.

Article 19

Paragraph 1

APAs are permitted up to 15 minutes to commercialize data. **Commercialization should not be permitted.** If, however, regulators decide otherwise, it *must be provided on a non-discriminatory basis, including with respect to any fees and access, including particularly the provision of non-discriminatory access to data feeds.*

Article 20

Paragraph 1

Consolidated tape providers are required to make available to the public continuous electronic data streams on a reasonable commercial basis. This service *must be made available on a non-discriminatory basis, including with respect to fees and access, including particularly non-discriminatory access to data feeds.*

Article 21

Paragraph 1

ARMs are required to make data available to regulatory authorities by the close of the following work day. **This is clearly inadequate.** Modern system capabilities enable this to be a far shorter time period for data that does not require extensive manual compilation and other specialized procedures. A two-day period may be reasonable for some special types of data, but will generally not be necessary for most information. This provision should establish the principle that each category of data must be available as soon as is technologically practicable after the necessary manual recordation of that data, but in no event later than the close of the same business day following the event.

Article 24

Paragraph 2

The trading mandate requires that the class of derivatives be admitted for trading on some venue and that the class be sufficiently liquid (Paragraph 3 provides technical standards to determine liquidity). If the class of derivatives is cleared by a CCP, that entity has determined that the class is sufficiently liquid that the losses on the close-out of a position in that class can be estimated at a level of certainty which is prudent. It is virtually tautological that if a prudentially regulated CCP is able to risk its capital on the liquidity of the market for a class of contracts in a time of great stress (since a member will have defaulted), that class of contracts is

liquid enough to be subject to the trading mandate. The liquidity standard in paragraph 2 must be deemed to have been met for purposes of the trading mandate if a CCP currently clears that subject class of derivatives. The standards of paragraph 3 should be used only for contracts which are not cleared.

Article 27

The requirements for non-discriminatory access by trading venues to clearinghouses are to be commended. However, it is recommended that the regulations mandate an active review by regulatory authorities of the reasonableness of capital requirements and potential operational roadblocks.

Further, the regulations must require the adoption of a central, disinterested system of allocating clearing capacity. Allocation of clearing capacity can be a vehicle used by financial intermediaries to create a Playing Field which is not Level. With multiple execution venues depending on the same clearing capacity on a real-time basis, the Level Playing Field envisioned by Article 27 can be easily evaded by techniques which bias allocation. **These anticompetitive practices, if allowed by regulators, will lead to a market structure that is not fully transparent, and one which is clearly discriminatory.**

Article 28

Non-discriminatory access to benchmarks is a crucial element of a fair and transparent market. In markets with low liquidity, for instance certain credit default swap markets, access to benchmarks is essential. Article 28 is an important protection as far as it goes. However, non-discriminatory access **should also be extended to trade repositories and regulatory authorities and access by regulatory authorities should be at no cost.**

Article 29

Paragraph 1

ESMA is authorized to temporarily prohibit or restrict the marketing, distribution or sale of certain financial instruments or financial instruments having certain characteristics or trading activities if specified conditions are met. **It must be made clear that the activities which may be controlled also include trading strategies and algorithms.**¹⁸ For example, an algorithm-based trading strategy which has the deleterious effects specified in Article 29 is a prime example of the type of activity which must be addressed and there should be no ambiguity on this point.

Paragraph 2

The standard for action is based in part on the orderly functioning and stability of the markets. The provision must specify the basic purposes of markets to establish that these functions require greater scrutiny. An example is transparent price discovery. In fact, several high frequency trading algorithmic structures are designed to seek and detect large orders and also to influence bid/ask spreads through large numbers of orders. These practices give the impression of significant market activity which is then rapidly cancelled. Since this strategy

¹⁸ Better Markets Comment Letter to CFTC, Proposed Rule, Core Principles and Other Requirements for Designated Contract Markets, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27994&SearchText=better%20markets>

directly impacts transparent price discovery, it merits strict scrutiny and probably deserves complete prohibition.

Paragraph 3

In addition to the matters discussed therein, the concept of Proportionality must be addressed in this area more specifically. **Benefits to individual traders in the form of profitability must be given less weight today in balancing regulatory approaches.** An example is an algorithmically driven high frequency strategy which provides minimal liquidity benefits to the marketplace, but generates large profits from the trader who employs it. The need for action to curb high frequency algorithmic trading to protect the markets from harmful disruptions must be considered freshly by regulatory authorities. The threshold against which this need for regulation is measured is relatively low because the activity provides little **useful** liquidity to the market. If the strategy actually benefitted the market as a whole, the regulatory threshold for risk of market disruption would be higher.¹⁹

Article 30

This Article parallels Article 29 in most respects, but applies to action by competent authorities. The Article should apply to financial instruments having certain characteristics (that is to say classes of financial instruments) as Article 29 does. The comments set forth above relating to Article 29 also apply with equal force here, particularly those applicable to trading strategies and algorithms.²⁰

Article 32

Proportionality is critical to position limits analysis. It must be addressed in great detail in Article 32. The core purposes of commodities markets are to provide a stable environment for businesses to hedge price risk and transparent price discovery. The level of speculative trading needed to accommodate core hedging activity is determinable.²¹ Speculative activity which either (a) exceeds this amount or (b) structurally does not aid or even impedes hedging and price discovery must be judged based on a different standard than that applied to necessary speculation. **In fact, any commodities speculation that exceeds liquidity requirements for hedgers definitionally is excessive. The idea of excessive speculation is a concept that has been codified in U.S commodities derivatives legislation, but has not yet been defined the same way in the EU. However, limiting excessive speculation conforms to the concept of achieving regulatory Proportionality in commodities markets.** *Excessive speculation must be addressed specifically in Article 32.* While paragraph 3 sets forth certain issues to be weighed in the exercise of position management powers, the value of trading behaviors and the core hedging purposes of commodities markets are ignored and this oversight must be addressed. Additionally, excessive speculation is not the same as manipulation. In the recent United States Dodd-Frank Legislation (title 7), the CFTC is mandated to provide position limits to stop manipulation *and limit excessive speculation*.²²

¹⁹ For a discussion of the relative value of high frequency trading see Cartea, A. and Penalva, J., "Where is the Value in High Frequency Trading?" Universidad Carlos II de Madrid, November 2, 2010.

²⁰ *Id.*

²¹ Better Markets Comment Letter to the CFTC, Proposed Rule, Position Limits for Derivatives, March 28, 2011, available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34010&SearchText=better%20markets>

²² Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 737(a); Commodities Exchange Act, Section 4a(a).

Paragraph 1

ESMA is authorized to take steps to limit a person's positions and/or require that they be reduced. The basic authorization must include the ability to act with respect to a class of persons. **A class of market participants pursuing a common or identical trading strategy can be just as disruptive of market functions as a single participant employing the same strategy. Many commodity index funds would fit this description by their own investment mandate.**

Paragraph 2

ESMA's authority is contingent on addressing a threat to the orderly function and integrity of the market or stability of the market as a whole. This provision must also specify the basic purposes of markets to establish that these functions require greater scrutiny. Price discovery and a stable, transparent and efficient environment for businesses to hedge risk are core purposes. Any speculative positions which impair the achievement of these purposes must be given far greater scrutiny. Paragraph 2 must explicitly address these core purposes and provide guidance as to specific issues. For example, the price discovery function is not merely the ability of producers and consumers to evaluate spot prices based on the most recently maturing derivatives prices. Longer term decisions, which affect the decision to bring supply into the market or store it, are determined by the extended derivatives price curve. Therefore, positions which distort any portion of the price curve can also damage core functions of the markets.

Moreover, the utility of commodities markets as a source for hedges relates to both costs of hedging and reliability. Positions and related trading activities which increase volatility over any time intervals (ranging from intra-day to closing prices and beyond, the longer interval volatility being often referred to as "boom/bust cycles") introduce price uncertainty. This uncertainty increases costs of hedging. Business risks are higher as uncertainty must be accounted for. This can be expressed in higher margin requirements, which puts pressure on the cash liquidity of hedgers. It can also be expressed as higher and/or more volatile prices, as hedgers must reserve against greater price risk. In any event, the cost is real and the utility of the commodities markets is reduced for the primary constituency of the commodities markets.

It is important to note that this is a real life example of conflicts between financial agents and principals. Financial intermediaries benefit from increases in market volatility. Speculative trading strategies are more profitable as a result of volatile price movements. Conversely their customers (including bona fide hedgers) are hurt directly from those same increases in volatility. If they hedge price risks, their margin postings are higher and unpredictable. The demand on funding liquidity is costly, and the risk of a catastrophic insufficiency of liquidity increases greatly. If they do not hedge, their business is at greater risk to spot market prices. Price volatility might result in lethal operating losses. As a result, they must fund greater reserves or otherwise use more costly methods to protect themselves.

Clause (b) provides that ESMA may take a decision only if "a competent authority or competent authorities have not taken measures to address the threat **or** measures that have been taken do not sufficiently address the threat." [Emphasis added] The fact that one or more competent authorities has acted is, by itself, an insufficient condition. It is likely that circumstances which require ESMA to exercise position management authority will arise across multiple marketplaces. The disjunctive "or" in the clause must be replaced by "and."

Paragraph 3

In addition to the need to address the principles set forth above, this paragraph is structured in a way which could inappropriately inhibit or call into question the appropriate exercise of the position management authority. It directs the ESMA to take into account several factors, for example the extent to which the measure “will not create the risk of regulatory arbitrage.” While the best interpretation is that ESMA can weigh the listed factors and others, the language may be misinterpreted to be more absolute. For example, any small difference between regulatory regimes involves some potential for regulatory arbitrage even if it is immaterial. *This paragraph must be amended to provide flexible guidance for an analysis based on principles of Proportionality.* For example, while the risk of regulatory arbitrage should be considered, the level of risk is important, and the tolerance for such risk is a function of the potential damage to the markets that is being addressed by the proposed measure under consideration by ESMA.

Proposal for a

Directive of the European Parliament and of the Council**Preamble**

In the preamble, several questions are posed and principles are articulated relative to the directive. Responses and comments are set forth below.

“It is appropriate to include in the list of financial instruments certain commodity derivatives and others which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments.” (Directive, page 10)

The appropriateness of the inclusion of certain commodities derivatives in the list of financial instruments depends upon the actual application of rules. Some rules are appropriate to all of the listed financial instruments. **However, commodity derivatives require unique regulation** as well. For instance, they provide important price discovery related to specific products. **As the Directive is refined and new text is added, each instance of overlap must be analyzed, and regulatory requirements unique to commodities derivatives must be considered.**

“To make European markets more transparent and to level the playing field between various venues offering trading services it is necessary to introduce a new category of organised trading facility (OTF). This new category is broadly defined so that now and in the future it will capture all types of organised execution and arranging of trading which do not correspond to the functionalities or regulatory specifications of existing venues. Consequently appropriate organisational requirements and transparency rules which support efficient price discovery need to be applied. The new category includes broker crossing systems, which can be described as internal electronic matching systems operated by an investment firm which execute client orders against other client orders. The new category also encompasses systems eligible for trading certain clearing-eligible and sufficiently liquid derivatives as prescribed in Regulation .../... (MiFIR). It shall not include facilities where there is no genuine trade execution or arranging taking place in the system, such as bulletin boards used for advertising buying and selling interests, other entities aggregating or pooling potential buying or selling interests, or electronic post-trade confirmation services.” (Directive, pages 11-12)

This is an essential element of a transparent market which is based on a Level Playing Field. **Trade execution must be moved from the shadow OTC markets that plagued regulatory authorities and policy makers as they fought to mitigate the damage to the financial system during the financial crisis.** In parallel, market participants’ access to the new market infrastructure must be open and fair so that market power cannot be used to the advantage of dominant participants.

However, here and throughout the Directive, more detail is required regarding open access. The Directive must address the many ways, both direct and indirect, that derivatives market structures can be used to create advantages for classes of market participants at the expense of others. Extreme concentration of market power (which means anyone’s test for oligopoly power) has been an enduring defect of derivatives markets, and contributed heavily to

the financial crisis of 2008.²³ The infrastructure of the marketplace depends on volume-based fees for revenue. In a concentrated market, institutions with market power can direct trading flows to infrastructure providers, which they thereby greatly influence with obvious negative consequences for a competitive and transparent marketplace. Better Markets has detailed the direct and indirect means and methods of market control and power in these markets in comment letters filed with the U.S. Commodity Futures Trading Commission (“CFTC”).²⁴

Ultimately, how transactions are executed and cleared and how trade data is captured and aggregated allows powerful trading institutions to distort essential agent/principal relationships with customers, both directly and by disguising the exercise of market power. Lack of transparency during the path of a transaction, from the initial order through execution, clearing and reporting, adversely affects the market as a whole. When this occurs, fair and open agent/principal relationships needed between financial institutions and customers are trumped by conflicts of interest.

To change these historic and continuing flaws in the derivatives markets, the Directive must be more forceful and specific in certain areas. This is particularly important in the articles relating to the infrastructure of the markets. **Market access must be fair and open so that financial agent influence is eliminated and/or substantially reduced.** Specifically:

- **Inducements for market flow must be eliminated.** These inducements can be in the direct payment for volume. They can also be in the form of discounts for services, revenue or profit shares, equity interests and targeted structural influence on decisions which lead to trading and customer-related advantages.
- **Access to information on the markets, both pre-trade and post-trade, must be open and equitable.** This includes both **quantity and quality** of data as well as the **speed** with which data is made available. Market advantages are more and more a function of the speed with which orders can be placed and cancelled and the asymmetrical acquisition of information needed to inform trading strategies. Time is measured in tiny fractions of seconds and decisions are automated using algorithms because direct human intervention is too slow. Asymmetry of information can both trigger disruptions and amplify their effects. Select disclosure of any kind of customer order tracking information must be eliminated, whether customer specific or anonymous, or on an aggregate basis. It is important to note that any disclosure of customer information, even if the customer is not identified, is valuable order flow information. This is especially true when the information is aggregated together and then disseminated in an asymmetric manner (for instance sold to the highest bidder). The Directive must establish the principles required to accomplish these standards if markets are to be truly open and transparent in the future.

²³ OCC’s Quarterly Report on Bank Trading and Derivatives Transactions, Fourth Quarter 2009, *available at* <http://www.occ.gov/news-issuances/news-releases/2010/nr-occ-2010-33a.pdf>.

²⁴ Better Markets Comment Letter to CFTC, Proposed Rule Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets; and Swap Execution Facilities, November 17, 2010, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26475&SearchText=better%20markets>; Better Markets Comment Letter to CFTC, Proposed Rule Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets; and Swap Execution Facilities; Additional requirements Regarding the Mitigation of Conflicts of Interest, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31090&SearchText=better%20markets>; Better Markets Comment Letter, Reopening and Extension of Comment Periods for Rulemaking Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, June 3, 2011, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=44794&SearchText=better%20markets>.

Of specific concern in the quoted provision is the broker crossing system proposal. Attention must be given to the algorithms which create matches. Automation of this process must lead to a fair and transparent result. The algorithms must not embed biases to achieve results that are not in the interest of individual customers. Standards for fairness of crossing systems must be explicit and detailed.

“These potential risks from increased use of technology [high frequency algorithmic trading] are best mitigated by a combination of specific risk controls directed at firms who engage in algorithmic or high frequency trading and other measures directed at operators of trading venues that are accessed by such firms. For example it is desirable to ensure that all high frequency trading firms are authorised when they are a direct member of a trading venue. This will ensure they are subject to organisational requirements under the Directive and are properly supervised. Both firms and trading venues should ensure robust measures are in place to ensure that automated trading does not create a disorderly market and cannot be used for abusive purposes. Trading venues should also ensure their trading systems are resilient and properly tested to deal with increased order flows or market stresses and that circuit breakers are in place to temporarily halt trading if there are sudden unexpected price movements. In addition to measures relating to algorithmic and high frequency trading it is appropriate to include controls relating to investment firms providing direct electronic access to markets for clients as electronic trading can be carried out via a firm providing electronic market access and many similar risks. It is also appropriate that firms providing direct electronic access ensure that persons using this service are suitable and that risk controls are imposed on the use of the service. It is appropriate that detailed organisational requirements regarding these new forms of trading should be able to be prescribed in more detail in delegated acts. This will ensure that requirements can be amended where necessary to deal with further innovation and developments in this area.” (Directive, page 19)

The remedies set out in the quoted language **are inadequate**, especially in light of the principle of Proportionality. Proportionally balanced regulation requires that rules governing trading activities must be based on **an assessment of the value of the trading behavior in relation to the potential harm that it may cause**. Proportionality focuses on the core purposes of markets. Derivatives and capital markets do not exist solely so that financial institutions can profit from a given trading strategy or technique. If a strategy or technique **may** involve material risks to the marketplace, offsetting market benefits serving the public’s interest must be the focus, rather than some given profitability to traders. In fact, the conflation of these benefits is a central cause of the systemic risk which precipitated the financial crisis.

The Directive must recognize the core purposes of markets so that regulatory authorities can properly calibrate rulemaking. For example, derivatives markets serve the related purposes of facilitating risk mitigation and price discovery for the business sector. To the extent a strategy or technique serves these purposes, it has value; its profitability may be important to a trader, but not to the interests of the public. As an example, one high frequency trading tactic is to place and cancel orders in rapid succession to detect large positions in the market and subsequently influence bid/ask spreads.²⁵ The high frequency trader can then predatorily position itself ahead of the large position by taking advantage of newly shifted bid/ask spread, which it created

²⁵ Better Markets Comment Letter to CFTC, Proposed Rule, Core Principles and Other Requirements for Designated Contract Markets, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27994&SearchText=better%20markets>.

solely for the purpose of tricking the larger position into the market. The profitability is substantial, but the social utility is non-existent.

Additional liquidity is the benefit most often cited in support of trading strategies and techniques. On this issue, **the concepts of volume and liquidity are often confused** and must be carefully analyzed as specific rules are developed. For example, high frequency trading based on algorithms undoubtedly increases volume. But, if the automated system withdraws liquidity from the market when liquidity is most needed (for example, when prices move beyond thresholds in reaction to unanticipated, non-fundamental forces), the practice cannot be said to provide a value to the market. The constant refrain from financial intermediaries that benefit from greater transaction volume that more “liquidity” is always necessary should be critically examined by regulators. Not all “liquidity” is alike, and many times new speculative volumes can actually be counterproductive to market structure. It is clear that the concept of proportionally balanced regulation can directly apply to the idea of liquidity. Since high frequency trading functions to withdraw liquidity from the market when it is most needed, it has no real value as a liquidity provider to the marketplace.

The remedy must also include speed bumps in the form of market pauses. These pauses can counter the tremendous momentum generated by automated and algorithmic trading. However, this is also inadequate. As Better Markets has proposed to the CFTC,²⁶ minimum time limits, prior to the cancellation of orders and prior to the exit of positions, set at a level that is consistent with human, not automated, perception must be established. Without such limits (or other, more prohibitive rules), tactics described in this proposal designed to distort market perceptions for tactical advantages cannot be facilitated by predatory high frequency traders.

“To give all relevant information to investors, it is appropriate to require investment firms providing investment advice to clarify the basis of the advice they provide, notably the range of products they consider in providing personal recommendations to clients, whether they provide investment advice on an independent basis and whether they will provide the clients with the on-going assessment of the suitability of the financial instruments recommended to them. It is also appropriate to require investment firms to explain to clients the reasons of the advice provided to them. In order to further define the regulatory framework for the provision of investment advice, while at the same time leaving choice to investment firms and clients, it is appropriate to establish the conditions for the provisions of this service when firms inform clients that it is provided on an independent basis. In order to strengthen the protection of investors and increase clarity to clients as to the service they receive, it is appropriate to further restrict the possibility for firms to accept or receive inducements from third parties, and particularly from issuers or product providers, when providing the service of investment advice on an independent basis and the service of portfolio management. In this case, only limited non-monetary benefits, such as training on the features of the products, should be allowed subject to the condition that they do not impair the ability of investment firms to pursue the best interest of their clients, as further clarified in Directive 2006/73/EC.” (Directive, pages 19-20)

The provision set forth (quoted above) establishes important and prudent principles for business conduct. The Commission and regulatory authorities must consider details of the interaction between dealers and customers in the implementation of these principles. A foundation of a properly functioning market is a transparent and conflict-free relationship between the dealer acting as agent and the customer acting as principal. History has shown that

²⁶ Id.

conflicts in this business relationship are rarely managed properly by the financial services industry in the absence of detailed regulation. The profit potential is simply sufficient to induce compromised ethics. The Better Markets comment letter to the CFTC on business conduct rules, footnoted below, provides important detailed requirements for the interaction between dealers and customers.²⁷ These are designed to require full disclosure of both the risks of an investment decision and the alternatives that may be less costly and involve fewer risks. **The guiding principle is that the customer must have access to all material information so that his or her decision is fully informed.**

In addition to the detailed rules, the explicit recognition of a fiduciary duty to the customer is important. The standards associated with this concept capture the level of responsibility needed to assure fairness and un-conflicted advice in a complex market. **The Directive should explicitly endorse a requirement of fiduciary duty by all financial intermediaries.**

“The financial crisis has shown limits in the ability of non-retail clients to appreciate the risk of their investments. While it should be confirmed that conduct of business rules should be enforced in respect of those investors most in need of these protections, it is appropriate to better calibrate the requirements applicable to different categories of clients. To this extent, it is appropriate to extend some information and reporting requirements to the relationship with eligible counterparties. In particular, the relevant requirements, to be specified by means of delegated acts adopted by the Commission, should relate to the safeguarding of client financial instruments and monies as well as information and reporting requirements concerning more complex financial instruments and transaction. In order to better define the classification of municipalities and local public authorities, it is appropriate to clearly exclude them from the list of eligible counterparties and of clients who are considered to be professionals. This classification should not exclude the possibility for these clients to ask a treatment as professional clients on request.” (Directive, page 22)

The immediately preceding response is relevant to the quoted language. There is no question that the exclusion of these entities from the list of eligible counterparties and designated professionals is necessary and appropriate. This is not only theoretically sound, it responds to multiple abuses from the past.

In addition, this provision must adopt an approach which better reflects the realities of the current marketplace, especially related to derivatives. The relevance of an investor’s level of sophistication is difficult to assess in the derivatives market. In an insightful article on information asymmetry in financial markets, Markus Brunnermeier draws the following conclusion:

One of our main results suggests that it may be computationally intractable to price derivatives even when buyers know almost all of the relevant information, and furthermore this is true even in very simple models of asset yields.²⁸

²⁷ Better Markets Comment Letter to CFTC, Proposed Rule, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, February 22, 2011, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27993&SearchText=better%20markets>.

²⁸ Arora, Barak, Brunnermeier and Ge, Computational Complexity and Information Asymmetry in Financial Products, page 2, October 19, 2009.

Even at large international financial institutions, there are few individuals who can appreciate the implications of complex derivatives and the interaction of positions within a portfolio.²⁹ A byproduct of the new marketplace is that sufficient sophistication depends on the instrument and the portfolio of the customer. If the rules do not reflect this, the dealer who specializes in the product and has a level of knowledge and access to analysis that far exceeds the resources of the customer will very likely use these to secure advantages over a customer which the customer will probably never discover. **Brunnermeier concludes that the seller of a derivative will often, in fact, cherry pick facts for disclosure to actively disguise information relating to the value of the transaction.**³⁰

The level of required disclosure must be a function of the type of instrument and its use, not just the status of the customer. While this means that the dealer must live with uncertainty, the principle of Proportionality leads to the conclusion that this is the only reasonable outcome given the extreme problem of agent/principal conflicts as manifest in the derivatives markets.

“Explicit powers should be granted to competent authorities to limit the ability of any person or class of persons from entering into a derivative contract in relation to a commodity. The application of a limit should be possible both in the case of individual transactions and positions built up over time. In the latter case in particular, the competent authority should ensure that these position limits are non-discriminatory, clearly spelled out, take due account of the specificity of the market in question, and are necessary to secure the integrity and orderly functioning of the market.” (Directive, page 26)

The recognition that market activities by a class of persons can be the basis for transaction limitations applicable to that class is very important. It recognizes the emergence of structural and algorithmic trading techniques in which **the activities of multiple participants can collectively have a massive effect on the markets.**

For example, commodities index fund investment trading activity is based on a highly structured trading process which is executed in lock-step by multiple parties trading against an index. These activities are the mirror of the assumptions underlying the index. The timing of both incremental investments (based in fund investment inflows and outflows) and the roll over of contracts to extend the duration of hedges are programmed precisely. All the investment programs using a common index adhere to these requirements automatically and therefore act in concert. **The collective activity of these disparate market participants is indistinguishable in terms of market effect from exactly the same activity if it were carried on by an individual entity.**

“Venues where the most liquid commodity derivatives are traded should publish an aggregated weekly breakdown of the positions held by different types of market participants, including the clients of those not trading on their own behalf. A comprehensive and detailed breakdown both by the type and identity of the market participant should be made available to the competent authority upon request.” (Directive, page 26)

²⁹ Id.
³⁰ Id.

While information from trading venues is useful, it is completely inadequate for purposes of analysis of the effects of categories of trading activity on markets. The number of venues is large and growing. Venue-generated information simply does not enlighten regulatory authorities of the relationship between the activities of market participants (and classes of market participants) and the markets. In fact, the siloed information can be misleading.

The overall activity of a market participant or class of market participants is required to provide a complete picture of the marketplace to the regulatory authorities. Each market participant has this data. **Specific classifications based on the purpose behind each transaction and position maintained must be established in the Directive.** The regulatory authorities must be provided this data, properly classified, on a weekly basis by the participant. The entire process must be geared to enable the regulatory authorities to easily perform analysis, not simply to compile data.

Classification is critical. The CFTC had to address this issue to gather information in preparation for the adoption of a position limits rule. **“Grouping of positions according to price relationships (hedge equivalents) was a critical initial requirement.”**³¹ While the classification system used in this rule designed to gather information prior to implementation of a trade repository system, is too limited,³² it still provides useful principles of classification.

Directive

Article 22 – Client Order Handling Rules

The Directive must take a much more detailed approach to the potential for conflicts of interest between dealers and clients, especially as it relates to derivatives. A top Wall Street derivatives expert was recently asked – confidentially – how many complex derivatives would be sold if the compensation was the same regardless of complexity and, without any hesitation, he said “very few.”

If there ever was a market that cried out for appropriate business conduct standards and robust disclosure rules, it is the derivatives markets. With grossly distorted compensation incentives, dealers create ever more complex products ostensibly customized to meet client needs, but which are, in fact, designed **not** to be understandable by anyone other than a derivatives expert.

As a result, the history of the derivatives markets is **littered** with disasters and scandals arising from transactions sold by dealers to customers who never knew or understood the ramifications of the complex financial instruments they were sold. From industrial companies like Proctor and Gamble and Metallgesellschaft, to financial entities like AIG, Long-Term Capital Management and Barings, enormous sums have evaporated from the balance sheets of major businesses through these instruments. And the losses to governmental entities like Orange County, California, Jefferson County, Alabama, the State of Wisconsin Investment Board, the

³¹ CFTC Rule, Large Trader Reporting for Physical Commodity Swaps, 76 FR 43851.

³² Better Markets Comment Letter to CFTC, Proposed Rule, Large Trader Reporting for Physical Commodity Swaps, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26632&SearchText=better%20markets>.

State of West Virginia and the Denver school district have directly cost the U.S. taxpayers in these states tens of billions of dollars.

This is just a selection of a few debacles that achieved headline status; many equally egregious, but less prominent, derivatives explosions have gone unreported. Is it any wonder that Warren Buffet referred to derivatives as “financial weapons of mass destruction?”

Derivatives risk is difficult to understand or even discern for those who are not experts in such products, including even sophisticated financial professionals who are fully capable of handling conventional financings. Anyone who has witnessed a sales pitch by a derivatives expert understands the sales person’s great advantage over the customer, and even greater potential reward. **This advantage is inherent in the complexity of the product.** Like the proverbial car salesman who understands that the real profit is in the “add-ons and extras” which are less understood by the customer, **financial markets professionals are incentivized to make the transactions as complicated as possible**, deriving much greater profit and compensation from each layer of derivative complexity and risk.

Transparency is the solution: full, clear and understandable disclosure plus availability of disaggregated information are the remedies.

- **The dealer must avoid, or at a minimum disclose, any conflicts of interest with the trading interests of the client.** Clearly, trading ahead of a client’s interests must be strictly prohibited. However, there are broader tactical and strategic interests of a dealer which could influence advice given to a client. These must be disclosed. It must be the prerogative of the customer, not the dealer, to determine if these tactical and strategic interests have influenced advice.
- **Seemingly complex transactions should be disaggregated and documented as straightforwardly as possible.** Many bi-lateral derivatives transactions are actually composites of much easier to understand derivatives risk. For instance, an interest rate swap and an oil swaption might be packaged to suit the specific needs of a customer. Each of these is independently easier to assess in terms of risk and easier to monitor in terms of results. The Directive must require that transactions be documented and priced separately, in their simplest forms.
- **Listed hedge equivalents must be required to be provided to customers.** Often, customers are sold esoteric derivatives when conventional, listed contracts could address their risks almost as precisely as the complex (and always very expensive) derivative transacted. The more esoteric a derivative is, of course, the more difficult it is to understand both the derivative itself and the pricing of the derivative. Not coincidentally, the more complex it is, the more profitable it also is for the dealer. Dealers must be required to provide customers the hedge equivalent alternatives and the appropriate information on price correlations.³³
- **Where credit arrangements are built into swaps through forbearance of collateral posting, the embedded credit and its price must be disclosed to counterparties separately from the swap price.** Often counterparties to dealers do

³³ This is directly related to the need for reported swap data to include hedge equivalent pricing for post trade analysis by regulators and the public.

not understand that a sophisticated financial institution would never take on credit exposure without pricing it and allocating it properly against total capacity for exposure to the counterparty. If a dealer allows a customer not to post, they are not providing that option for free. Like other aspects of the transaction, the price and the impact on credit availability must be disclosed.³⁴

- **Risk disclosure and scenario analysis must be provided by a dealer to counterparties and it must include information on liquidity and volatility with respect to the proposed swap.** These factors, along with counterparty risk, are at the heart of the complexity and unique risks of derivatives. Disclosures of risks and projected scenarios are completely inadequate without consideration of these factors.

Article 47B - Position Reporting by Categories of Traders

In the U.S. markets, there have been many studies of the effects of speculative trading (and in particular trading associated with commodities index fund investment) on the futures markets. The effort has produced several studies which failed to identify correlations between (a) investment inflows into, and outflows out of, commodities index funds and (b) futures prices. “However, more recent studies examining the cumulative effects of fund investments and liquidations and the continuous roll-over of futures (instead of incremental inflows and outflows) have found strong correlations.”³⁵ It is to be expected that the structure of each study is important to finding results in such a complex environment and that these structures would evolve over time.

The quality of available data has been a persistent problem for these and other studies. Positions must be captured and compiled. **But the greater challenge is categorization of data according to the purpose underlying the position.** Article 47B could be the foundation for a position data system which avoids these shortfalls.

Foremost is the requirement that the data conform to a common language. This is a deeper concern than common counterparty identifiers and product codes. One hallmark of derivatives markets is the diversity of products and complexity of contracts. Yet the practical effects of diversity and complexity on data capture and aggregation are often overstated.

General principles must be laid out for guidance:

- Positions must be aggregated based on the purpose of the individual transactions. Hedges of physical positions must be defined by rules and separately reported. **Commodity index fund activity must be in a unique classification.** And other speculative activity must also comprise a separate category.
- Positions of entities must be aggregated based on common pragmatic interests. All positions must be **aggregated at the control entity level.** Trading firms must not be allowed to establish multiple entities to avoid position limits. Regardless of how

³⁴ The separate pricing for post trade disclosure, addressed in other proposed rules, is an obvious boon for price transparency, and the same principles apply here. Furthermore, clarity of pricing will promote competitiveness which will ultimately benefit the customers and the public.

³⁵ Better Markets Comment Letter to the CFTC, Proposed Rule, Position Limits for Derivatives, March 28, 2011, available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=34010&SearchText=better%20markets>.

the position is expressed by an entity (what venue and whether listed or OTC), positions should be aggregated into equivalent positions. That way, regulators are not mandating the choice of venue or structure, but limiting the position to an aggregate level across venues and/or structures. In other words, all positions should be viewed at the control entity level by regulators. Hard and fast rules are inadequate, but a number of factors have been identified which are useful to craft meaningful aggregation rules.

- **Functional liability for risk:** this can include direct liability, guarantees, keep-well agreements and third party support (such as letters of credit) provided by parents or affiliates.
- **Responsibility for investment decisions:** important considerations are organizational structure and reporting lines into common managers.
- **Consolidation of trading books:** the ultimate beneficiary of profits (and losses) must be considered as indicative of a point of aggregation.
- **Common trading procedures:** this can be an explicit or implicit agreement to trade in tandem. It can also be a functional result, such as multiple commodity index fund traders using the same or similar indices which require the same trading activities on the same dates. **It must capture collective activities which are indistinguishable in terms of effect from an individual trading entity engaging in the same activity.**
- **Positions must be based on underlying risk rather than transactions.** Many bilateral derivatives transactions are actually composites of much easier to understand derivatives risk. For instance, an interest rate swap and an oil swaption might be packaged to suit the specific needs of a customer. Yet, for all practical purposes of position calculation, the oil swaption component is the equivalent of a free-standing oil swaption. Disaggregated position calculations would achieve this result.
- **Positions must be grouped according to market price relationships.** Groupings must have a rational basis, reflective of the market practices. “[Product] aggregation would involve the aggregation of OTC derivatives activity in one product with other OTC derivatives products sharing common risk factors.”³⁶ The process is well understood by financial institutions and central counterparties. Although implementation poses a challenge, the pathway is well travelled.

These relationships are essential to the valuation of positions, especially in relation to less liquid contracts. Less liquid contracts involve complexities, but they do not exist in a vacuum. Their pricing is related to contracts that are exchange-traded and relatively liquid. Identification of these exchange traded contracts is largely a matter of examining market practices. For instance, less liquid swap positions are often hedged with futures contracts using quantity ratios based on price-change correlations. Similarly, options are often valued based on delta-equivalent futures positions (*i.e.*, futures contracts in a notional value reflecting the differences in price move dynamics between the option and the underlying.).

³⁶ Report, page 23.

These liquid equivalent contract prices can serve as a foundation for valuation of swaps. Similarly, delta equivalents can then be used for options.

For swaps, basis differentials to liquid reference prices can be used as available (which may be less frequent than changes to the hedge equivalent contract) but changes to liquid reference prices cannot be ignored.

This disaggregated reporting focus is not a novel proposition. If it is not required, the regulatory standards will lack the fundamental, common “language” used by market participants to express the value of a given position and value their positions.

If the position data do not explicitly include these types of information, their potential usefulness is greatly diminished. **A central goal of the Directive should be to develop independent valuation processes which, at a minimum, employ the techniques universally used in the financial services industry.**

We hope that our observations and suggestions are helpful to you in the development of these important documents.

Sincerely,



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