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**Comments of the Zentraler Kreditausschuss
on
CESR's Consultation Paper
“Guidance to report transactions on OTC derivative instruments”**

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A. General comments

The ZKA welcomes the opportunity to comment on CESR's considerations concerning transaction reports on OTC derivatives. We wish to call your attention to the fact that our concerns which we expressed during consultation 09-618 have not yet been addressed to our satisfaction: we still have considerable doubt as to whether it is appropriate to specify details of a data exchange at this point in time. Up to now, only a small number of EU member states have introduced transaction reporting for OTC derivatives – thus the exchange of data is useful only for these few members.

What makes things more complicated in our view is that there do not appear to be any adequate links between the considerations of CESR and the considerations of the European Commission on the regulation of the OTC derivatives markets. In the summer of 2009, the Commission had presented its Communications COM(2009)332 and COM(2009)563, one objective of which is to increase transparency for regulators. Transaction reporting as specified in article 25 MiFID has the same goal. However, we do not consider the extension of transaction reporting to include all OTC derivatives mentioned in the consultation paper to be sensible. The banking industry (G14) has already introduced a central trade repository for credit default swaps (CDS) in which the contract data of these OTC derivatives are kept; for equity derivatives a trade repository is underway. These databases could be used for various regulatory purposes, including the detection and investigation of potential market abuse cases. Thus it would make sense if these data were analysed for multiple purposes by the regulatory authorities instead of generating a separate report for each individual purpose. This would prevent the production of redundant data while significantly increasing data consistency, as, for example, the data of CDS are already matched in the DTCC. In particular, credit default swaps should therefore be exempt from transaction reporting as per article 25 MiFID in order to achieve the highest possible data quality in this area. We strongly welcome CESR's recognition of the activities in this area and suggest that CESR support the work of the Commission in this aspect and specifically investigate how the desired trade repositories could be made usable. This could result in improved data quality and a significantly better cost/benefit ratio for everyone involved. Our comments below are subject to this fundamental reservation.

Transaction reporting as per article 25 MiFID may be useful for creating transparency for those products where contract data cannot be retrieved via trade repositories. With respect to the scope of applicability of such expanded transaction reporting, it must be noted initially that

article 25 MiFID is the starting point. Against this systematic background it becomes clear that only OTC derivatives which are mirror products are covered by Article 25 MiFID, i.e. derivatives which in the first or n-th derivation are based on a financial instrument admitted to trading on a regulated market. This is reflected in Section D, where it says on page 4 that “CESR decided that only transactions on securities derivatives whose underlying instrument is traded on a regulated market should be exchanged.” An arbitrary expansion to other OTC derivatives appears to be neither consistent nor necessary. However, the restriction undertaken by CESR is not complied with consistently in the consultation paper. Thus there are some examples in which other derivatives are used. This inconsistency should be eliminated. We believe it is absolutely necessary to formulate a coherent and unambiguous definition of the term OTC derivative subject to transaction reporting, as otherwise the quality of the reports would be considerably impaired.

The list of instrument types (page 7) makes it clear that the considerations are heavily influenced by the London market. A simple extension to the entire Internal Market does not appear to be appropriate. In order to enhance clarity, we suggest that the number of instrument types be reduced to six:

1. OTC options, including OTC-warrants
2. Forwards
3. Contracts for difference (CfD), total return swaps (TRS) and spread bets
4. Credit default swaps (CDS) -if these derivatives should be subject to transaction reporting at all
5. Equity swaps (excluding CfD, TRS, spread bets)
6. Other derivatives.

We will explain this classification more precisely in the following comments and responses. However, for reasons of clarity we follow the categorisation used by CESR in our answers.

B. Answers to the individual questions

Chapter I. A to E: Population of fields per type of derivative

Q1: Do you agree that the Unit Price should be the premium per single underlying of the contract as it is in market practice and not per contract?

Yes. In practice the strike price, fixed or starting price is listed *per unit*; in this case it is listed *per share*.

Q2: Do you agree that the Venue Identification should be XXXX in order to differentiate transactions on OTC derivative instruments from off-market transactions of instruments admitted to trading, marked as XOFF? Do you think this should also be the case if the transaction is executed on an MTF?

It is not clear what added value the introduction of a third category XXXX would generate. The report must differentiate whether the transaction was completed on an organised market (then the code for this market, either that of the regulated market or the MTF must be specified), or over the counter i.e. OTC (then the code XOFF must be given). However, from a mere technical point of view all variations could be implemented in the reports.

Q3: Any other views on the above?

“Quantity”

The description of the “Quantity” field should be expanded to include the term “notional amount of OTC derivatives” for purposes of clarity. For example, this must be listed for swaps (cf. the examples on pages 14 and 15 of the consultation paper).

Chapter II: OTC options

We suggest combining OTC options and OTC warrants in the same category for the sake of clarity. The primary difference between these two instruments is usually in maturity, which however does not justify separating them. This also becomes clear on page 11 of the consultation paper, where it states that “OTC warrants are long-term call or put options.” For this reason the designation “OTC option including OTC warrants” appears to be more sensible.

Moreover, warrants are frequently instruments admitted to trading on a regulated market which are already subject to transaction reporting. Combining non-listed warrants in the category “OTC options including OTC warrants” would therefore also contribute to clarity.

Q4: Do you agree that in the case of multiple expiration dates, the field should be filled in with the latest expiration date?

Yes, this is the only sensible solution for American-style OTC options, as they can be exercised at any time.

Q5: Any other views on the above?

No.

Chapter III: OTC Warrants

Cf. our general comment on Chapter II, OTC Options.

Chapter IV: OTC Futures/Forwards

The term “futures” is used exclusively for contracts traded on regulated markets. For reasons of clarity this category should therefore be called “Forwards”.

Chapter V: Contracts for Difference (CfDs)

The products “contracts for difference (CfD)”, “total return swaps (TRS)” and “spread bets” are very similar in structure. This is also reflected in the descriptions on pages 13-16. For example, on page 16 it says: “Spread bets are often considered to be a retail version of a CfD.” Furthermore, these are partially products which are widely distributed only in particular markets of the EU; a division into three categories therefore does not appear to be practical or justified based on the significance in the Internal Market. We therefore suggest combining them in a single category: “Contracts for Difference (CfD), Total Return Swaps (TRS) and Spread Bets”.

Q6: Any views on the above?

CfDs are actually swap transactions in which there are no buyers or sellers. We therefore suggest leaving the “Buy-Sell Indicator” field empty for CfDs.

Chapter VI: Spread Bets

We suggest creating a single category “Contracts for Difference (CfD), Total Return Swaps (TRS) and Spread Bets”; cf. our comment on Chapter V.

Q7: Do you agree that the Quantity field should contain the amount of the “bet”?

Yes. However, at the same time we need a general clarification for all CfDs, TRSs and spread bets, according to which the purchase amount and/or the notional amount must be reported in the “Amount” field.

Q8: Do you agree that the Unit Price field should contain the reference price for the transaction?

The Unit Price field should be filled in with the initial price, which is the firmly agreed price. The reference price, on the other hand, is in practice the price determined on a valuation date based on the price source (e.g. Eurex or Bloomberg).

Q9: Do you agree that the Unit Price should be in the currency of the underlying instrument?

The currency specified in the unit price should correspond to that of the initial price. The currency of the underlying, on the other hand, is not relevant and does not even exist in some cases (e.g. for no-par stock).

Q10: Do you agree that the Price Notation field should reflect the currency of the underlying instrument even when the spread bet is made in a different currency?

Cf. our response to question 9. The currency of the initial price should always be decisive, regardless of whether the OTC derivative covers one or multiple currencies.

Q11(a): Do you agree that the Price Multiplier field should be populated to validate what movement in the price of the underlying instrument the spread bet is based on e.g. 100 for 1 point (cent/penny); 1 for 1 euro/pound movement?

Yes.

Q11(b): Do you agree that the spread bet will normally be based on a movement of one point (cent/penny) movement in the price of the underlying instrument and the Price Multiplier field should only be populated when the spread bet is not based on a movement of one point?

Yes.

Q12: Do you agree that a transaction report is required for opening and closing a spread bet and for the expiration of a spread bet?

The starting point for a report must always be a purchase or sale. In an opening transaction this will usually be the case. In a closing transaction this is not the case, so that closing

transactions should not be subject to transaction reporting. However, if a position is neutralised by concluding an offsetting position, this is a purchase or sale subject to transaction reporting. However, the intention of the contract partner is unimportant; it is only important whether a purchase or sale was made. The (simple) expiration of a contract, on the other hand, is not usually tied to a purchase or sale, so that no report is generated. We wish to point out that the expiration of exchange-traded derivative contracts does not trigger transaction reports either.

Q13: Do you agree that an option on a spread bet on an equity is not a complex derivative as the terms of the bet can be accommodated in the transaction reporting fields?

Yes.

Q14: In relation to spread bets on other MiFID instruments, do you have any views on how the fields in a transaction report should be populated?

According to CESR's decision (cf. CESR/09-1036) transaction reporting is limited to those OTC derivatives whose underlying is a financial instrument admitted to trading on a regulated market. The characteristics of these instruments can be described using the fields discussed in the consultation paper.

Chapter VII: Equity Swaps

In general, it must be noted that the description of this instrument on page 19 of the consultation paper is only an example. The comment that equity swaps are usually concluded subject to the ISDA Agreement should be deleted. Equity swaps are also concluded to a notable degree under the German master agreement; likewise, the French market also has its own standard.

Q15: Do you agree that the buyer of the Equity Swap (Buy/Sell Indicator field, B) should be the Fixed Rate Payer?

Equity swaps are actually swap transactions in which there are no buyers or sellers. We therefore suggest leaving the "Buy-Sell Indicator" field empty. In addition, we wish to point out that the term "fixed rate payer" is not generally used for the equity leg in contracts; there the term "equity amount payer" is preferred.

Q16: Do you agree that the Quantity field should be the notional value of the Equity Swap?

Yes, this rule should likewise apply to CfD, TRS and spread bets.

Q17: Do you agree that the Unit Price field should contain reference price of the underlying equity on which the equity returns are calculated?

No. The Unit Price field should be filled in with the initial price, which is the firmly agreed price. The reference price, on the other hand, is in practice the price determined on a valuation date based on the price source (e.g. Eurex or Bloomberg).

Q18: Do you consider that when the initial reference price is not known when the Equity Swap is traded, this product should be considered a Complex Derivative?

No. This product is not a complex derivative just because the component initial reference price is not known on the trading date. The field "Price" should therefore be left blank. Usually the initial price/strike is set based on the closing price on the stock exchange on a certain date in the future and no longer negotiated. A later reporting of the price in the form of a second transaction report should likewise not take place; this would create considerable problems in the reporting systems, as plausibility checks would not permit second reports. We therefore suggest that the investment firms required to do the reporting supply this information upon request to the regulatory authority.

Q19: Do you agree that Equity Swaps with two Equity legs should be reported with two different transaction reports with the same Transaction Reference Number for both reporting firms?

An equity swap with two equity legs will always trigger two transaction reports by each of the two swap partners involved. For technical reasons there will be four different transaction reference numbers. Company A will report a purchase and a sale with two different reference numbers, and Company B will also report a purchase and a sale with two different reference numbers. Plausibility checks will reject two different reports with the same reference number as erroneous. The unique reference number is absolutely necessary for purposes of unambiguous referencing; this applies, for example, to cancellations (cf. our answer to question 18).

Chapter VIII: Credit Default Swaps

The statement according to which credit default swaps are comparable to insurances should be deleted. A CDS is an OTC derivative, not an insurance.

Q20: Which instrument should be reported as the ultimate underlying instrument for a CDS? the market clip, the reference bond if any , or the ISIN of the stock of the issuer ? (Warning : these are mutually exclusive options, i.e. participants would not have the choice between different reporting options. Once one of them has been selected, it would become the only standard for reporting)

Credit default swaps should be exempted from transaction reporting as per article 25 MiFID. They are not generally based on a specific financial instrument and thus do not fit the CESR approach of subjecting those derivatives to transaction reporting which are based on an instrument of a single issuer admitted to trading on a regulated market. CDSs usually refer to general categories such as borrowed money or bonds. The term bonds generally refers to an obligation, including those which are not listed on a regulated market. In its considerations on pages 24/25 of the consultation paper, CESR shows that it sees these problems, but does not offer any convincing solution.

Also, the definition of an OTC derivative in CESR's glossary is not applicable to CDSs since the value of a CDS does not depend on the value of an underlying , but on the probability of default of the reference entity and the recovery expected for bonds or borrowed money.

As already described under A., we consider it absolutely necessary that CDSs not be subject to transaction reporting as per article 25 MiFID, but rather to have the regulatory authority analyse the existing extensive contract data in the trade repository (DTCC-Trade Information Warehouse). This is the only way to prevent data redundancy while simultaneously achieving the highest possible data quality. We believe this is the only way to ensure that the regulatory goals are actually achieved.

Should CESR insist on subjecting CDSs to transaction reporting despite the numerous practical difficulties described, it should consider covering only those CDSs in which the parties (i) have agreed a "reference obligation only" and (ii) the reference obligation is a listed security. In any case it should be avoided referencing anything not reflected in the contract. The RED code is a matching criterion of the DTCC which is used only as an aid to identify the issuer.

Q21: Do you agree that the price should be an equivalent all-running payment price expressed in basis point?

We fundamentally reject subjecting CDSs to transaction reporting. Should CESR insist on subjecting CDSs to transaction reporting despite the numerous practical difficulties described, the price of the standard coupon agreed by the parties as well as the upfront premium should be

reported. The statement of an all-running payment price would cause unnecessary additional calculation expenses.

Q22: Do you agree the price notation should be the currency of the debt protected by the CDS?

We fundamentally reject subjecting CDSs to transaction reporting. Should CESR insist on subjecting CDSs to transaction reporting despite the numerous practical difficulties described, the contractual currency which is stored in the systems should be reported.

Q23: Do you agree that early terminations should be reported, while assignments and compression should not be reportable?

We fundamentally reject subjecting CDSs to transaction reporting. Should CESR insist on subjecting CDSs to transaction reporting despite the numerous practical difficulties described, each transaction of each contractual partner should be reported only once, at the time of the conclusion of the contract (purchase or sale). We do not consider reporting of early terminations necessary, as this would result in disproportionately high costs. The same applies to assignments and compressions; these should not trigger transaction reporting (cf. our answer to question 12).

Chapter IX: Complex derivatives
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We view the idea of introducing a “complex derivatives” category very critically. As is obvious in the comments on page 27 of the consultation paper, this category is meant to serve as a “catch basin” for those OTC derivatives that do not fit into the other categories. We therefore suggest the use of the term “other OTC derivatives”, as the term “complex derivatives” would be misleading. In the current political debate, the latter is used to describe derivatives which could have adverse effects on the market and might be subjected to special equity capital requirements or even completely prohibited.

Q24: Do you have any other relevant examples that should be added into CESR guidelines? Please give detailed explanations of the example.

No.

Q25: Do you agree that the Instrument Description field should be required to be populated at local level, in order to explain the derivative being reported?

No, the cost/benefit ratio would be disproportionate.

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