Trading on OTC derivatives. March 2011

The G20 at the Pittsburgh summit agreed a commitment according to which all standardised OTC derivatives should be traded, where appropriate, on exchanges or electronic platforms before the end of 2012.
To concrete this mandate, the FSB published a report in October 2010, issued by the CPSS (Committee on Payment and Settlement Systems), IOSCO and the European Commission, that included 21 recommendations.

Recommendation no. 13 urged IOSCO to conduct an analysis of the different issues to be consider in the process of moving trading of OTC derivatives to markets or electronic platforms. The report of the IOSCO Task Force on OTC Derivatives Regulation (TF), published last February, responds to this request.

The introduction first describes derivative markets, and then analyses what can be understood as organised platform for the purpose of OTC derivative trading. The next section deals with standardisation and liquidity of OTC derivatives, as key elements to determine whether the trading of an OTC derivative in an organised platform would be feasible.

The next section discusses the benefits and costs associated with the movement of OTC derivative trading to organised platforms. This section also explores other benefits and costs associated to other reforms, also agreed by the G20 and closely linked to this process (standardisation of OTC derivatives, central clearing and transaction reporting to central data repositories).

The following section of the report proposes three possible routes for regulators to support the transition process: establishment of timetables for the move of trading, establishment of an incentive system and creation of regulatory measures.

In the last section, the TF presents its conclusions emphasizing that trading of standardised derivative contracts is feasible through electronic platforms or markets, provided that a flexible approach allowing adaptation of the type of platform to the level of liquidity and standardisation of derivatives is taken.

This flexible approach is used for defining the concept of organised platform. In this sense, the TF considers that there is no single model, but instead there are several trading mechanisms or models that can be considered as organised platforms, as long as they meet certain minimum requirements. According to the conclusions of the TF, these are the minimum requirements:

- Registration with a competent authority.
- Access based on objective and fair criteria that are applied in an impartial manner.
- Pre- and post-trade transparency appropriate to the nature and liquidity of the product.
- Operational efficiency and resilience (including measures to handle contingency situations).
- Market surveillance capability.
- Transparent rules governing the operation of the platform.
- Rules that do not allow an operator to discriminate between participants under equivalent conditions.

In addition, the TF identified an additional characteristic that platforms should have, but the TF members are not in agreement about it: platforms should offer the possibility to trade with multiple providers, in what is known as multi-dealer platforms (as opposed to single-dealer platforms). As mentioned above, the lack of uniformity in this interpretation could lead to situations of regulatory arbitrage.

Finally, the TF recommends to coordinate regulators actions taking into account the range of measures that regulators can undertake to carry out the transition to organised platforms.

Link to the press release: http://www.iosco.org/news/pdf/IOSCONEWS196.pdf

Link to the report: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf