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Letter submitted by e-mail to consultation-2014-06@iosco.org

Subject line of email: "Consultation Report on Risk Mitigation Standards on Non-Centrally Cleared OTC Derivatives," text in Microsoft WORD format

Comment may be made publicly available.

Reference: "Consultation Report on Risk Mitigation Standards on Non-Centrally Cleared OTC Derivatives"

Mr. David Wright
IOSCO Secretary General
IOSCO
Calle Oquendo
28006 Madrid
Spain

16 October 2014

Dear Mr. Wright,

The firm of Thomas Murray wishes to thank IOSCO for the opportunity to comment on the proposal for establishing guidance for risk mitigation standards on non-centrally cleared OTC derivatives. This is critically important work for the world's interconnected public and private capital markets. IOSCO is to be complimented for the clarity of its consultation report, its avoidance of jargon and limited use of legal terms. IOSCO has stated well what it sets out to achieve.

IOSCO notes that despite the damage to the world financial system and economy in the period 2007-2009, OTC derivative contracts, as tracked by the BIS, continue to grow.

Not only will this IOSCO project add transparency and legal certainty to outstanding OTC contracts, the firm believes that a more solidly established non-cleared OTC environment may reduce the pressures to put such contracts into CCPs. Thomas Murray has very publicly expressed concern about the risk to central clearing infrastructures of

commercial pressures being applied to them to take contracts onto their books that might not be easily understood or valued. For this reason, we appreciate IOSCO's work in putting pure, non-standardised OTC on a better footing.

The firm

Thomas Murray is a private firm registered in the United Kingdom, and founded 21 years ago. It is owned by 90 individual investors; there is no institutional tie of any kind, assuring the independence of viewpoint that is essential for credible analytical and advisory services.

Uniquely, the firm's business is devoted solely to capital markets infrastructure institutions, and its analyses cover 430+ such establishments in more than 100 marketplaces. 75 persons work for the firm, and we endeavour to provide current, detailed information to our clients. The question which led to the founding of Thomas Murray was global custody, and from there the business coverage spread by geography and line of business. Today the firm's analytical coverage includes central securities depositories, custodians (global, national, and sub-custodian), settlement houses, and registrars, as well as clearing houses.

Thomas Murray's CCP assessment programme has led to a considerable deepening of the firm's expertise on the subject of clearing, notably at a time when OTC contracts were being directed into this space and utterly upsetting the previous ways of working. The programme was launched at the beginning of 2012 at the request of global banking clients, and with their backing. It has been clear since the 2009 G20 Pittsburgh summit that the policy expectations in terms of capital markets risk management were changing considerably in the clearing field.

Our clients asked for the firm's assistance in projecting forward what the commercial outlook might be when the regulatory changes then being written would come into effect; and also what their increasing capital requirements might be as participants. One of the striking results from this work is continuing discomfort as to the cut-off for « standardised OTC contracts » which must be centrally cleared, what exactly they are, and then the great mass of pure OTC immediately nearby with the unknowable influence of its values and counterparty positions as they may affect the regulated, public markets.

Thomas Murray believes that its extensive knowledge of financial markets institutions generally, and of CCPs in particular, may give weight to the comments which follow.

General comments on the current consultation

The importance to the world economy and financial system of establishing this set of standards is well stated in the Introduction. Despite all the confusion, uncertainty, and damage that can be attributed to OTC derivatives because of the poor quality of information about them and the shoddy administrative practices that have characterised them, the BIS statistics show that they continue to proliferate. IOSCO is right to move forward with guidance that would establish basic, common administrative procedures for those who continue to deal in these instruments.

Given the firm's expertise in clearing house assessment, Thomas Murray concurs with the IOSCO statement that not all OTC would ever lend itself to the CCP environment, and indeed quite the contrary. It is best to keep the bespoke separate from the off-the-peg.

As concerns background point iii, the firm would emphasise the less-than-optimal value of margin being exchanged by OTC counterparties, given all the information that follows in this report about the poor information on which these values are often established. We appreciate the minimum standards on margin requirements for non-centrally cleared OTC derivatives established by BCBS and IOSCO in September 2013, but note that without the proper business administration of these contracts as now being proposed, the minima are bound to remain approximate.

The firm strongly agrees with IOSCO's response to the need for promoting legal certainty and facilitating dispute resolution as well as the management of counterparty risk. This latter point has great significance for the counterparty positions lying within the regulatory perimeter. We must all bear in mind for now that until clarity can be provided for total additive counterparty positions in trading, clearing, and settlement within and outside the regulatory perimeter, there will remain a great cost to the financial system in the form of uncertainty.

Conclusion

In reading the IOSCO consultation report, it is astounding to learn in 2014 that large swathes of OTC derivatives still remain so poorly followed in administrative terms. We wonder how it can be that a corporation or a partnership can enter into binding agreements so casually, without accounting controls in place that are validated by internal audit and the statutory auditor. This being the case, management itself cannot have definite ideas of its own open trading positions, let alone external parties trying to assess them.

It concerns us that methods of pricing these contracts should still vary so wildly when, as highlighted by yourselves in the consultation report, it was such disparities that led to the huge bailout of AIG. A marketplace where prices cannot be agreed is no marketplace at all. Whilst we understand that the pure OTC contracts referred to in this consultation lie outside the regulatory perimeter, perhaps IOSCO could use this work to suggest to the Financial Stability Board/G20 that these common standards be used for centralised national reporting in their jurisdictions based on common definitions. This would help to establish defined prices, as well as building up a picture of the size of the market. The world economy and financial system require coherent, consistent information on these contracts.

IOSCO is to be strongly commended for the good sense shown in addressing this knotty problem in the form of guidance for a financial realm that remains largely unregulated, and so beyond its direct purview. The firm's detailed comments on the guidance standards follow in annex.

We remain respectfully yours for questions you may have,

Sincerely,

Thomas Krantz
Senior Advisor Capital Markets

Alex Harborne
Senior Analyst

CC: Simon Thomas, Jim Micklethwaite, Tim Reucroft, Xiang Li, Janet Wynn, TM

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Standard	Thomas Murray remarks
Scope of coverage	1.6 The standard must be applied to covered and non-covered entities, or the temptation for covered entities to deal outside the scope of this guidance would reduce the value of this exercise to an unknowable extent. In any case, every entity contracting OTC should surely be subject to preparing audited statements, in which case these positions need to be captured and evaluated by all. 1.7 The contractual relationships between entities reporting OTC positions and their third-party service providers should be subject to internal audit and statutory audit validation. IOSCO is right to insist that the ultimate responsibility for meeting the standards cannot be delegated.
Trading relationship documentation	2.1 It would seem from the need to establish this standard that under current practice OTC derivatives are poorly documented between counterparties. This is plainly unacceptable business practice, and likely to be a violation of commercial law in many jurisdictions . 2.5 It would appear that there are still undocumented non-centrally cleared OTC derivatives transactions taking place, which seems inconceivable as a business practice. 2.6 The minima documentation proposed for counterparty documentation constitutes an excellent list that must be included. 2.7 The time frame for establishing bilateral relationship documentation must be tightened up. « A reasonable period » is unreasonably long.
Trade confirmation	3.5 It is again inconceivable that the two counterparties to an OTC derivative trade are not confirming the material terms of their contract with one another. 3.6 Negative confirmation of transactions seems a strange way to proceed. I believe IOSCO and its supporters are looking for greater simplicity and transparency in a zone that is lacking in both.
Valuation with counterparties	4.3 An agreed methodology for valuation throughout the life of the contract must be in place from the start. The IOSCO standard must use the word « must, » not « should. » How could this be otherwise in a contractual arrangement ? 4.5 If the valuation methodology is proprietary and cannot be disclosed to the other party, then to whom should it be disclosed ? How could the two parties agree without understanding this ? Perhaps a table of valuations derived from the secret methodology

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	could be shared and agreed ? 4.6 If we accept that for thinly traded non-centrally cleared OTC derivatives there is often no common agreement on valuation process and/or methodology, then why would anyone transact ? Is this a game of deception, or a fair and valid financial transaction?
Reconciliation	Reconciliation at « regular intervals » must be tightened up to be effective, and tied into the contracting party's regular business processes timetable. 5.3 Portfolio reconciliation should be performed for every transaction, without the qualification of « to the extent practicable. » How can one have a contractual commitment that goes unreconciled?
Portfolio compression	6.4 Thomas Murray believes that portfolio compression will have great information value for the marketplace and its overseers. We also underscore the point that the reduction in the number of transactions outstanding reduces operational and settlement risk.
Dispute resolution	7.3 Before starting to deal OTC derivatives, the entity must have pre-determined dispute resolution procedures in mind. These should indeed be part of the bilateral contract.
Implementation	The implementation date for these standards must be more precisely stated than «as soon as practicable. » Once the comments are received and the standards corrected, the IOSCO Board should mandate a global starting date for its member authorities to assure.
Cross-border transactions	A contract is a contract. No one is forcing any entity to transact across borders; this is a commercial choice, which must be properly documented before being entered into. Globally-set IOSCO standards would go a long way into setting minima information and procedures that will be generally standardised. Until they are in effect, when in doubt an actor should simply abstain.

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