

These Principles were developed by the Association in coordination with its member firms all of which operate as inter-dealer brokers in the North American wholesale markets. The Association's members do not provide identical services and their capabilities are constantly evolving to better suit their customers' needs and those of the marketplace as a whole. As a result, the Association anticipates that these Principles will likewise evolve over time. We welcome receiving comments on the Principles from market participants, regulators and other interested parties. Comments should be addressed to wmbaa@pattonboggs.com.

The Wholesale Markets Brokers' Association, Americas

Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets

The Economic Utility of OTC Financial Products and Markets.

OTC Products: A wide range of beneficial over-the-counter (OTC) financial products are used by businesses, banks, broker/dealers, insurance companies and investment funds to manage their every day risks. OTC products are those financial contracts, financial instruments, and commodities that are not listed and traded on a central exchange but are entered into by sophisticated institutional investors through bilaterally negotiated transactions over the phone or on an electronic platform. They include a broad range of "cash" instruments (e.g. fixed-income government and corporate securities, foreign exchange and forward commodity contracts) as well as a large array of derivatives (e.g. interest rate swaps, credit default swaps and energy swaps). Just as farmers routinely hedge against a future drop in commodity prices, corporate debt issuers, manufacturers and commodity producers routinely use OTC contracts to hedge the interest rate, credit, commodity and currency risks associated with their business operations. Indeed, sovereigns and central banks historically used these OTC markets daily to finance their debt, engage in monetary policy and/or to stabilize their currency in the international markets.

It has been estimated that more than 90 percent of Fortune 500 companies use OTC derivatives among other OTC products. Prudent risk management practices, including the use of OTC hedging instruments, have long been encouraged by bank regulators and other financial supervisors. FAS 133 in fact permits an entity to recognize a derivative that hedges an asset, liability, future cash flow or foreign currency exposure in its statement of financial position, if certain conditions are met. However, in order for a company to engage in such hedge accounting and incorporate the offsetting nature of a derivatives hedge in their financial statements, there must be a close and consistent correlation between the derivative and the underlying asset or

liability. Absent a well functioning OTC market for privately negotiated and highly customized OTC swaps, most U.S. companies would be unable to avail themselves of the favorable accounting treatment currently available under prevailing U.S. and international accounting rules.

OTC financial products thus have broad economic and financial utility. Used properly, they are vital to the U.S. economy, domestic and international commerce and our future prosperity.

OTC Markets: America has some of the largest, most efficient and most liquid OTC markets in the world. These OTC markets – the market for fixed-income securities, repurchase transactions, interest rate swaps, credit default swaps and foreign exchange – are all critical to the smooth functioning of our capital markets and their role in the global financial system. Many OTC markets feature a high degree of electronic execution, central counterparty clearing (CCP) and usage of electronic trade confirmation, settlement and reporting utilities. Our OTC markets are highly efficient because they allow for a variety of execution venues to link to a clearing utility that treats all execution venues equally and on a non-discriminatory basis. OTC markets have produced many important innovations in risk management and have experienced historically no greater amount of materially adverse disruptions or counterparty default than listed exchange markets. Due to the high levels of competition amongst the trading venues, OTC markets are larger, more cost effective and more conducive of innovation than exchange traded markets. For instance, trading in U.S. Treasury securities, whose gross trading volume exceeded \$1.042 Quadrillion in 2008,¹ occurs in an OTC marketplace that has operated successfully for years with oversight responsibility vested in the U.S. Treasury Department under the Government Securities Act of 1978. Today, the U.S. Treasury market is the world's largest and most liquid, with efficiency, transparency, electronic automation and centralized clearing. We are fortunate that market participants from around the globe prefer to invest in and hedge through U.S. OTC markets, such as the U.S. Treasury market. We believe that destroying or impairing these markets would not be in the national interest.

Key Role of Wholesale Brokers in OTC Markets: Wholesale brokers are neutral intermediaries that facilitate access to OTC and exchange traded pools of liquidity across a full range of asset classes and their associated derivatives. Wholesale brokers execute transactions in OTC products and serve a similar role to a stock or futures exchange matching buyers and sellers in bilateral transactions. Typical trading volume through wholesale brokers is approximately 20-40% of the total wholesale market volume in any given product type. In OTC markets with central counterparty clearing, wholesale brokers effect transactions and then present the trade to the clearinghouse. In some OTC cash and derivative markets, wholesale brokers utilize highly sophisticated electronic execution systems with automated trade confirmation and straight-through-processing links to market participants. Wholesale brokers also provide OTC market transparency through publication of unbiased and independent market and pricing data. Our members currently publish market information through a variety of readily accessible sources worldwide.

¹ Depository Trust & Clearing Corporation, 2008 Annual Report, pg. 34.

Importantly, wholesale brokers and their professional staffs are extensively regulated in the U.S. by the SEC, the CFTC and FINRA and abroad by numerous regulatory agencies, including the UK's FSA. It is estimated that each day wholesale market brokers handle on average about two million OTC trades corresponding to about \$5 trillion in size across the range of FX, interest rate, credit, equity and commodity asset classes in both cash and derivative forms.

Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets.

The members of WMBA-Americas advocate the following principles:

There is a Need to Strengthen and Enhance the U.S. OTC Financial Markets.

As an increasingly significant sector of the global market economy, the U.S. OTC markets should be strengthened and enhanced through well considered and focused structural and regulatory enhancements that do not compromise the efficiency, flexibility and innovativeness that counterparties have come to expect from the OTC markets. WMBA-Americas believe that building even more transparent, efficient and well functioning OTC derivatives markets should be the collective goal of industry, regulators and public policymakers.

WMBA-Americas, therefore, supports the following principles:

1. **More Effective Regulation of Wholesale OTC Markets and/or their Participants.** WMBA-Americas supports more effective regulation of the OTC cash and derivatives markets to enhance market safety and soundness and to provide regulators with effective tools and means to monitor and police markets and market participants. Any legislative or regulatory changes should be focused and carefully considered, well crafted and effective, and should not stifle innovation, market liquidity and product development that are the hallmarks of the OTC markets. WMBA-Americas supports enhanced OTC markets regulation that keeps American OTC markets competitive and strengthens participants' confidence in these critical markets.
2. **Centralized Clearing.** WMBA-Americas supports the development of central counterparty facilities for the novation, clearance and settlement of OTC contracts including OTC derivatives. Members of WMBA-Americas have long participated in existing clearing facilities in several of the larger OTC markets (e.g. foreign exchange, fixed income securities, options on securities, repurchase transactions and increasingly stock lending) which have played substantial roles in dramatically reducing systemic risk. We support the migration of standardized OTC swaps transactions to recognized and open central clearing facilities. Consistent with those proven historical examples and in order to promote market efficiency and pro-competitive principles, WMBA-Americas believes that central counterparties should be required to be open, neutral and provide all execution platforms with non-discriminatory access to the clearing facilities.

3. **Alternative Execution Venues.** WMBA-Americas supports greater use of hybrid broker-assisted and electronic trading systems in all OTC products and markets where feasible and not detrimental to either market liquidity or excessively costly. Our members currently facilitate electronic execution of OTC transactions through many of their existing technologies and sophisticated trading platforms. For example, we estimate that today over 50 percent of trading in credit derivatives outside of the U.S. is conducted electronically on trading platforms operated by members of WMBA-Americas. The symbiosis between electronic and voice trading is demonstrated by the hybrid model of trading. The hybrid model of trading OTC, which enables participants to trade simplified products on screen (with pre-trade transparency) and more complicated products over the phone (with post-trade transparency), has been proven to be an effective means of providing suitable transparency and liquidity to the market. Such a hybrid way of trading can be operated by one entity or multiple organizations providing each service. This means of trading is also utilized by certain exchanges who offer real-time electronic execution and post trade reporting services to their members.

4. **Greater Regulatory Transparency.** Wholesale brokers can provide a great deal of transparency to the OTC markets. Such transparency helps preserve market integrity and prevent systemic risk. We support efforts to enhance the stability of the U.S. OTC markets by ensuring that regulators have an accurate picture of market conditions and the activity of all participants in the wholesale markets. We support reporting of trade information for purposes of regulatory review and oversight through data warehouses and a central trade repository. Our members stand ready to assist such market utilities through connectivity to our pools of market liquidity and transaction volume processed daily through our members' transaction processing and trade capture systems. Technology based reporting systems, that can be used for voice and/or electronically executed trades, can provide regulators with expeditious trade data information from which they can seek to identify: (i) suspicious trading activities, (ii) inappropriate levels of credit and market risk in given marketplaces and (iii) critical information on overall financial conditions and market dynamics. We therefore favor the deployment of systems that provide regulators with enhanced audit trails and enable regulators to better police against manipulative behavior.

5. **Automated Trade Processing.** We support greater automation of transaction processing and can assist the industry's migration towards the straight-through processing of OTC transactions utilizing our members' automated trade processing facilities and systems. We also support greater standardization of OTC derivatives, mandatory usage of automated confirms and the adoption of hybrid, broker assisted and electronic trading systems wherever practical. Broader industry usage of trade capture facilities and hybrid electronic trading systems can help provide regulators with a real time picture of the marketplace and help prevent misconduct.

6. **No Mandatory Exchange Execution.** We do not support the forced channeling of OTC trading or its markets and products onto regulated exchanges. Such efforts would be counterproductive. It would stifle innovation and competition and raise transaction costs. U.S. futures exchanges generally have no experience facilitating institutional customers' wholesale market transactions in important OTC derivatives, such as credit derivatives. In contrast, members of WMBA-Americas facilitate thousands of electronic transactions in these products every day. Forcing OTC transactions onto exchanges will drain liquidity and damage healthy markets. It will also discourage U.S. businesses from the sort of prudent risk management practices recognized in our hedge accounting rules and make our markets less competitive globally. Wholesale brokers, through their regulated electronic trading platforms and transparent post-trade systems for voice trades, can achieve the desired efficiencies and transparency without stifling competitiveness and new product development.

7. **Encouraging Competition and Innovation.** Efforts should be made to enhance institutional investors' confidence in the integrity and fairness of our OTC markets. Sophisticated market participants should have the ability to choose when, where and how they will trade and manage their risks. The development of new competitive trading venues should be encouraged, not discouraged. Innovation should not be stifled by increasing barriers to entry – barriers that would become insurmountable if there was mandatory exchange trading of OTC derivatives.

8. **Avoiding Waste.** We also believe the industry's already significant investment in OTC derivatives market infrastructure should be viewed as a foundation from which regulators and legislators can achieve their goals of systemic risk oversight. Forcing the entire wholesale OTC derivatives markets onto exchanges or electronic-only trading systems, whether they are operated by wholesale brokers or not, fails to recognize the substantial investments the industry has already made to improve market infrastructure and liquidity and discourages the industry from making such investments in the future.

Regulated Electronic Transaction Execution Systems. The U.S. Treasury Department's White Paper on Financial Services Industry Regulation identifies "***Regulated Electronic Transaction Execution Systems***" ("RETES") as suitable platforms for execution of OTC derivatives transactions. We believe that many of the electronic trading platforms operated by the U.S. wholesale brokers are an exact match for the RETES concept. With decades of experience in providing institutional customers with deep and liquid markets in cash and derivative financial products as well as neutral and non-proprietary trade execution services, our members utilize both actively-used electronic trading systems and sophisticated pre and post-trade transaction support technologies (including, automated trade capture and confirmation systems) thereby providing regulators with enhanced transparency. Nevertheless and as demonstrated over the last 12 months, electronic-only trading is not necessarily suited to all products, trading strategies or specific market conditions. Therefore, it is important that the complementarity of electronic and voice execution platforms are understood and that these alternative solutions enable participants to carry out their trading strategies in the most efficient



manner possible. To this end, WMBA-Americas would like to explore with U.S. policy makers the expansion of the RETES concept to cover voice traded systems that utilize effective post-trade transaction support technologies and confirmation systems to provide suitable regulatory transparency.

WMBA-Americas and its members look forward to working with U.S. policy makers, legislators and regulators in developing the RETES criteria and other regulatory standards while continuing to serve their customers in healthy U.S. financial markets for decades to come.