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Response

Consultation Report: "Regulatory Issues Arising From Exchange Evolution"

Technical Committee of The International Organization of Securities Commissions (IOSCO)

March 2006

I. Introduction and Summary

1. The Federation of European Securities Exchanges (FESE) welcomes the opportunity to respond to the IOSCO Consultation Report: "Regulatory Issues Arising From Exchange Evolution". FESE **supports the overarching objectives** of the Report with regard to updating the 2001 Report and raising the awareness of IOSCO members regarding the measures taken by other supervisors to address the issues they may be facing in relation to conflicts of interest.

2. Members of FESE, which account for nearly 40 exchanges in Europe, have extensive experience with the issues discussed in the Report. European exchanges have been at the forefront of demutualization and conversion to for-profit structure which have gained wide traction around the world today. These processes have in large part been driven by increased competition and technological innovation. Moreover, due to the unique experience of the European integration process, the regulatory environment faced by FESE members has also undergone major changes over the last decade, specifically in the last five years, with important consequences for the regulatory role of exchanges and their interaction with other market participants, investors and the market as a whole.

3. By and large we find the Consultation Report **clear, well written, and balanced**. Based on the experiences of our members, we broadly agree with the key recommendations of the Consultation Report, especially with regard to the recommendation of **greater cooperation between supervisors** and **information flow between exchanges and supervisory authorities**. Moreover, we believe that there is **no need for IOSCO to revise any of the standards** referred to in the report. Additionally, in the context of Europe, we **do not see any need** for **national authorities** to review and supplement the measures in place in their jurisdictions.

4. Our views on the issues raised in the Consultation Report, explained in further detail in the next section, can be **summarised** as follows:

- The implementation of the FSAP in the EU has meant that many of the traditional regulatory roles delegated to exchanges have been curtailed and/or taken over by the securities supervisors (the impact of these changes varies from country to country depending on the national legislation that existed before the FSAP). This **regulatory transformation** clearly mitigates the potential conflicts of interest that are defined in the Consultation Report, since the exchanges do not have many of the roles assumed to create a conflict of interest with their demutualized, for-profit structures.

- On the other hand, exchanges have retained certain regulatory functions and/or share responsibilities with the securities supervisors in several areas. In all of these areas, the maintenance of high regulatory standards by an exchange does not contradict its for-profit purpose, but rather it is **a prerequisite for commercial success** through positive branding and reputation. This is because exchanges, irrespective of whether they are mutualised, demutualised, for-profit or not-for-profit, listed or unlisted, have an interest in ensuring that they offer **fair, orderly and efficient marketplaces** for buyers and sellers, whether these are members, users, or customers of members and users. To

ensure that their markets are attractive to buyers and sellers requires surveillance by exchanges and their operators of transactions which are made subject to exchange rules and regulations and using exchange approved facilities. That is as much a commercial imperative as a regulatory imperative.

- Fairer markets attract investors; thus, demutualization and conversion to for-profit structure does not conflict with a commitment to high regulatory standards. FESE's members' continuing commitment to the highest standards of self-regulation, whether they be demutualized, private or not, proves this.
- In addition to the market incentives for good regulation, an exchange also enjoys **proximity** to its market, which allows surveillance of its markets and users in a manner that is impossible for supervisors receiving delayed transaction reports and other market information. For all these reasons we **caution against regulators taking over SRO tasks** and **intervening unduly** in the internal structure of exchanges.
- Exchanges and supervisors share a common strong interest in a well regulated market. Both in the EU context and more globally, the market operator / regulator relationship works best when it operates as a "**partnership"** - there must be a shared understanding between market operators and regulators given their common desire and purpose in ensuring and maintaining well regulated markets. This partnership needs to be based on high-level international standards regulating not just the relationship between exchanges and regulatory authorities but also for the roles and responsibilities of regulatory authorities (e.g. for investment firms, multilateral trading facilities (MTFs) and exchanges). The EU's FSAP sets out high standards for these areas in Europe. Complementary to this, the IOSCO principles could provide the basis of a global convergence to high level standards that minimize regulatory arbitrage.
- Finally, the Report should more explicitly recognise that **evolution does not only mean demutualization** or conversion to for-profit structure; it includes, for example, the emergence of systematic internalisers and MTFs/ECNs. These developments raise some problems which also need to be taken into consideration in any analysis of the evolution of the role of exchanges.

5. Below we provide our comments in the following structure:

   II. Comments on the four basic findings of the study;
   III. Comments on the two main questions posed by the Report; and
   IV. Comments on the Report's conclusions and recommendations.

II. Comments on the four basic findings of the study (Section E)

6. The fundamental purpose of exchanges is to allow multiple buyers and sellers to come together to set prices at which they will buy and sell financial instruments. Exchanges, irrespective of whether they are mutualised, demutualised, for-profit or not-for-profit, listed or unlisted have an interest in ensuring that their marketplace offers a fair, orderly and efficient environment for buyers and sellers, whether these are members, users, or customers of members and users. To ensure that their markets are attractive to buyers and sellers requires surveillance by exchanges and their operators of transactions which are made subject to exchange rules and regulations and using exchange approved facilities. That is as much a commercial imperative as a regulatory imperative. In fact, demutualization might reduce the conflicts of interest in certain areas (this is hinted at, but could be discussed more extensively, in Section B2a of the Report).

7. In addition to the market incentives which foster good self-regulation by exchanges, which apply at a global scale, there are also factors more specific to the EU that mitigate the potential conflicts of interest. Namely, the regulatory role of exchanges has undergone a major change as a result of EU legislation (FSAP) over the last five years, affecting all of the main areas mentioned in Section B1.

8. For example, the **Market Abuse Directive** has shifted the primary responsibility for detecting and preventing market abuse to competent authorities. The **Prospectus Directive** has shifted the responsibility for approval to competent authorities (existing delegation of powers to cease by 2008 unless a Commission study finds otherwise). Similarly, as acknowledged by the Report on pages 13 and 15, the **Markets in Financial Instruments Directive (MiFID)** establishes a common framework for the regulation of exchange members, exchanges, users of MTFs, and MTFs. In addition, issues such as access to regulated markets and governance structures have been clearly addressed in MiFID.

9. In our view, the discussion of the potential conflicts of interest discussed in Section B2 in the context of the EU needs to take into account the large extent to which the new regulatory framework limits the scope of potential conflicts of interest.

10. On the other hand, these changes do not mean the elimination of each and every self-regulatory role for exchanges in the EU. While regulatory authorities in certain countries, and certainly those in the EU as described above, might have been given prime and/or statutory responsibilities for authorisation and ongoing oversights of investment firms (including credit institutions), prospectuses, listings, market abuse, and oversight of exchanges, it is exchanges that have the technical and human expertise and resources to monitor intra-day trading, transactions, and, particularly in the case of derivatives exchanges, positions. For example, although the above-mentioned directives limit the direct regulatory role of exchanges in Europe, regulated markets still continue to have certain functions which are vital to securing safe and orderly markets, as explicitly recognised in these directives.

11. For example, despite the changes introduced by MAD as described above, trading surveillance remains part of exchange responsibilities, which requires exchanges and regulators to work closely together in monitoring for, detecting, and investigating potential market abuse (see, for example, the provisions related to the prevention and detection of market abuse as established in Article 6 Para 6 of MAD and Article 43 of MiFID). Competent authorities are in many cases too remote from trading to detect abuses and rely heavily on exchanges to identify market abuse, although the competent authorities might then assume primary responsibility for investigating the suspected abuse. Prevention is difficult; enforcement action will discourage abuse and rules and regulations state what is abuse, but that is not the same as prevention. Hence, there is a strong argument for competent authorities and exchanges to be "**partners"** in ensuring the integrity of markets.

12. Consequently, regulatory authorities and exchanges ***share*** responsibility for market integrity; without an enormous increase in the resources of regulatory authorities that is likely to continue to be the situation for the foreseeable future, which is why exchanges continue to perform a certain set of regulatory functions important to the quality and integrity of the market.

13. The model established in the EU largely corresponds to such a partnership model. This "partnership" requires on the one hand regulators not to intervene in key areas that could restrict the capacity and approach of the exchange to determine its self-regulatory functions. On the other hand, it requires a regulatory framework set by law that takes into account the needs of an exchange to carry out its self-regulatory functions. While the FSAP is a very good basis for this framework, the FSAP measures may need to be revised at some point in the future with the purpose of bringing the different provisions fully in line with the requirements of a partnership model as described above.

14. There are also some aspects of the FSAP Directives where the shift of the supervisory responsibility from regulated markets to competent authorities – in conjunction with greater potential fragmentation of trading due to proliferation of execution venues - might bring new challenges to the marketplace as a whole. For example, the three different venues provided for post-trade transparency for investment firms to execute their obligations under Article 27 and 28 of MiFID, of which regulated markets is only one option, could lead to data dispersion with unpredictable consequences for price transparency and

best execution. Thus, the Report should note that, while most of the steps undertaken by securities lawmakers and regulatory authorities *"to ensure that exchanges continue to perform regulatory functions in a proper manner"* have been appropriate, some of the steps taken towards these or other objectives may have unintended consequences that frustrate these objectives.

15. We agree in principle with the approach taken in Section D2 summarised by the statement that the *"challenge for regulators is to allow normal commercial practices as much freedom as possible but to recognize that in the exchange environment they also need to protect the principles of pricing integrity, client interests and best execution. This requires regulators to have both clear principles in respect of incentive schemes and a good understanding of the incentive schemes being used by trading platforms, whether located in their own jurisdiction or offering competing services from external locations."* However, as all of these regulatory principles are already addressed in the EU context via the FSAP measures, we see no need for the authorities to consider additional measures to ensure competitive behaviour in the context of the markets where FESE members operate. Of course, IOSCO provides the perfect forum for regulators to learn from each others' experiences as regards revising regulatory standards in face of technological and product change, and the EU's experience should be illuminating in this process.

16. Regarding Section D4 c) "Cross-border corporate groups", although we agree with the overall analysis in this section, we would like to underline that the regulatory and supervisory efficiency of the overall framework established by the Lamfalussy process has a very important impact on the regulatory role of exchanges. The efficiency of the supervisory and regulatory cooperation has to continue to improve in order to facilitate cross-border groups such as Euronext or OMX among the FESE membership. For example, some aspects of the implementation of MAD have already been identified as obstacles to the smooth operation of the cross-border supervision of such groups.

17. We agree with the need to consider the pressure on regulatory authorities in Section D8 and believe that more attention needs to be paid to these pressures.

18. To the extent that commercial functions can be considered to create conflicts of interest for the regulatory role of the exchanges, it should be recognised that exchanges can employ a variety of effective methods to ensure that their regulatory functions are not impacted on negatively by their commercial functions. Our members employ a range of tools in this regard.

19. We agree with the need to consider conflicts and inconsistencies between exchange and listed company legislation (Section D9). In our experience, these conflicts are adequately addressed by the Prospectus Directive and the Transparency Directives which have shifted the duty of enforcing initial and ongoing disclosure obligations to the competent authorities.

20. The financial resources of exchanges in Europe are regulated in MiFID which mandates that a regulated market must have *"available (…) on an ongoing basis sufficient resources to facilitate its orderly functioning."* (Article 39(1) (f)). Thus we see further capital requirements for exchanges as unnecessary and support the EU's decision not to impose any such requirements as outlined in the White Paper for Financial Services Policy 2005-2010.

21. With reference to D3, we would like to note that the extension of exchange activities to new fields is in itself a positive thing for the shareholders and the users. Such innovation creates benefits to customers and to the market as a whole.

22. Similarly, we see outsourcing (D5) as an essentially positive outcome for the exchanges' customers since it allows exchanges to use specialist expertise. Since the regulatory obligations remain with the regulated entity, i.e. the exchange, there is no risk of reduced oversight of the activity that is outsourced.

23. Finally, we agree that when exchanges have decided to self-list (B2d), *"all the jurisdictions of SC2 members have considered specific measures and taken appropriate steps to deal with the particular conflicts and issues that arise."* Self-listing is a practice that has taken place in many jurisdictions without any negative consequences for the investors or the market as whole.

24. Moreover, self listing (and more generally listing) has proven to be very effective in reducing the impact of conflicts of interests in listed stock exchanges. Particularly the broadening of the shareholder base decreases the conflicts of interests deriving from the overlapping of owners/users that characterises the mutualized exchanges. In addition, listed exchanges are subject to thorough market scrutiny, in particular over managerial choices. Listed exchanges are more flexible with regard to fund-raising, and therefore can easily finance IT development, strategic alliances. The status of a listed company strengthens corporate disclosure and enhances governance.

III. Comments on the two main questions posed by the Report (Section E, page 29):

> *(i) Do the existing regulatory requirements for exchange licensing/registration and operation continue to be adequate and easily adaptable to the emerging issues or are new tools necessary?*
>
> *(ii) How should the new business activities of exchanges be considered and included in the regulatory framework?*

25. We consider that the existing regulatory requirements for exchange licensing/registration and operation in the aftermath of MiFID in particular are fully adequate and easily adaptable to the emerging issues and that no new tools are necessary. Moreover, the FSAP rules and/or national rules in the EU are sufficiently flexible to take these into account.

IV. Comments on the Report's Conclusions and Recommendations (Section E)

26. In line with the observations we have made above, and by way of summarising our **main conclusions**, we would like to provide brief comments on the Report's conclusions below:

    - We support the recommendation with regard to closer *"ongoing dialogue with exchanges"* in the Conclusion 1.
    - While we support the general principle that *"[r]egulatory authorities should assess whether the changes being made by exchanges require any adjustments to the regulatory framework for an individual exchange or for exchanges generally, and should address any such need for changes promptly"*, as we have outlined above, we believe that the post-FSAP environment effectively addresses conflicts of interest for exchanges both by limiting their regulatory role and also by establishing measures to address potential conflicts of interest.
    - The principle that *"Regulatory authorities should carefully assess the impact on resources of any changes to the regulatory model for exchanges, and ensure that the core regulatory obligations and operational functions of exchanges are appropriately organized and sufficiently resourced"* is supported. On the other hand, we caution against regulatory authorities taking over or unduly interfering with SRO tasks.
    - Moreover, we believe that MiFID adequately addresses these concerns in the EU by allowing market operators sufficient room to design and employ their own sophisticated risk management techniques. In this context we support the EU's decision not to impose any additional requirements in this area.

- We support the recommendation that *"regulatory authorities should be prepared to share relevant information concerning cross-border activity"* and believe that CESR sets the appropriate context for such exchange of information to occur. As pointed out above, the EU has made great progress in this area through the establishment of the Lamfalussy process and this progress should be continued by streamlining supervisory and regulatory cooperation.
- Above all, we should note that competition among exchanges occurs more and more at a global level and acts as an important competitive force. Furthermore, if implemented well, the regulatory environment set up by the FSAP can be expected to reinforce these competitive market forces in the context of Europe and play a key role in addressing the policy concerns raised in this Report.