FEDERATION OF EUROPEAN SECURITIES EXCHANGES

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Dear David,

The treatment of derivatives in the context of the application of the European Code of Conduct for Clearing and Settlement for Cash Equities

After finalization of the Code of Conduct for Clearing and Settlement for cash equities in November 2006, Commissioner McCreevy announced that his services would evaluate asset classes other than cash equities, including derivatives and fixed income, in the context of the Code. The Code itself includes a reference on possible extension of the self-regulatory approach to other asset classes.[1] The issue will be discussed briefly during the upcoming Monitoring Group meeting of 21 January.[2] Following a request for written comments from the Commission during the latest meeting of the Monitoring Group, FESE would like to share some preliminary views on derivatives markets:

1. **Our primary focus should be on the implementation of the Code of Conduct for cash equities**

   FESE agrees with the Commission that the primary focus should currently remain on implementation of the Code of Conduct for cash equities. We believe that the implementation of the three pillars of the Code—Price Transparency, Access and Interoperability and Service Unbundling and Accounting Separation—by our members and the members of EACH and ECSDA will contribute significantly towards the goal of achieving a stronger, more efficient, and more integrated European capital market. The Code of Conduct for cash equities is complementing MiFID in delivering more competitive and efficient European securities markets by enhancing cross-border post-trading services in Europe. In this respect, in order to achieve the goals of MiFID, and, in particular, develop competition between trading venues on a level playing field, we encourage the Commission to focus on the implementation of the Code of Conduct for cash equities ensuring that the Code applies to all participants in the cash equities trading, clearing, and settlement arena, including recently created trading venues.

[1] Article 4 of the Code of conduct states the following: 'The Organisations understand that the Commission is considering proposing to the Organisations the further extension of the Code once it has entered into force. The Organisations will then consider the extension of the self-regulatory approach to other asset classes and service providers, as well as any differing provisions of the Code which may apply to such asset classes and service providers. This review will take place at the time of implementation of the MiFID (Markets in Financial Instruments Directive). Prior to any such review, Organisations may apply all, or some, of the provisions of the Code to other instruments if they so choose'.

[2] http://ec.europa.eu/internal_market/financial-markets/docs/code/mog/20071010_report_en.pdf,

2. Any new initiative should be subject to better regulation principles

With respect to any possible regulation or self-regulation in derivatives markets, FESE considers that it will be important to identify first whether there is a market failure in derivatives markets and - if there is such a failure - to consider potential solutions and to determine the best approach to address it. The Commission should consider the proportionality of its approach as well as evaluate any potential regulation against other regulatory objectives. Clearing and settlement of derivatives differs substantially from cash equities. If the Commission considers that self-regulation is appropriate, FESE believes that it would be necessary to negotiate within a new, specific context to address the issues that are relevant for derivatives markets given the substantial differences between cash equity and derivatives markets. Furthermore, firms operating in the derivatives arena differ from those that have signed the Code of Conduct for cash equities; the right institutions must be involved in discussions to ensure that the approach is appropriate.

The Code of Conduct for Clearing and Settlement for cash equities was developed in response to the high costs and inefficiencies of cross-border post-trading services. This was documented by exhaustive market analysis. On the contrary, cross-border settlement services in derivatives markets differ substantially in that derivatives go through physical settlement only rarely (i.e., fewer than 5% of derivatives transactions executed on regulated markets result in delivery[3]; the vast majority of OTC contracts are settled in cash rather than through delivery).

3. Functional approach to ensure level playing field among market participants

If a regulatory or self-regulatory approach is deemed necessary in derivatives markets, it is essential to involve all relevant market participants in the discussions. FESE members believe that any regulatory or self-regulatory initiative must ensure a level playing field among firms that stand in competition, i.e., follow a functional approach in market definition. First, regulated derivative exchanges and clearing houses play an important role in derivatives markets and must be involved in discussions. Second, other platforms offering derivatives products and services must also be included. Third, since a high (and increasing) proportion of derivatives trading takes place over the counter, firms offering OTC derivatives must also be included.[4] It should be recognized that regulated derivatives exchanges, other derivatives trading platforms, and firms offering OTC derivatives in many cases offer both competing and complementary products and services. Applying regulation or self-regulation to one set of firms exclusively could put these institutions at a competitive disadvantage. More specifically, not supporting the level playing field between listed and OTC products by imposing more stringent requirements on listed products would unduly favour the development of OTC markets. Favouring the development of OTC markets to the detriment of regulated markets could have unintended consequences on the stability of the financial system as a whole.

[3] Source: FESE members' estimation. The low delivery rate is due to most customers of derivatives markets who do not wish to make or take delivery of the instrument or commodity underlying the derivatives. Consequently, market users will generally offset their initial position before the contract settlement date.

[4] FESE notes that during the last MOG it was suggested that the report on "New developments in clearing and settlement arrangements for OTC derivatives" published by the Committee on Payment and Settlement Systems (CPSS) in March 2007 (available on the BIS website) may provide helpful input.

4. **European derivatives markets face global competition**

The European derivatives markets have proven to be dynamic and innovative, as recognized by EU Commissioner Charlie McCreevy in his 4 December address at the Eurofi conference.[5] This dynamism has led to dramatic growth in the availability of and demand for derivative products as well as a strong competitive position vis-à-vis U.S. derivatives markets. Given that the market for derivatives is global, FESE believes that any potential intervention by the EU targeting European derivatives markets could have negative effects on the competitiveness of European derivatives markets. This is particularly important as in most EU markets and certainly in the US, listed derivatives service providers tend to operate in vertically integrated structures (whether by ownership or by process) where the trading venue and the clearing house cooperate closely. Indeed, the close involvement of the clearing house is essential in the development of new derivative products to ensure that it can properly assess the risks of clearing these products. This close cooperation allows derivatives trading venues to innovate quickly and release new products in response to customer demands and most importantly to compete with their US counterparts.

5. **Conclusion**

FESE members are strong supporters of the Single European Market in Financial Services. FESE supports the operational and financial efficiency of trading and post-trading services. Before considering an intervention for asset classes other than cash equity, there is a need to analyse potential market failures in these markets. The appropriate regulatory tool as well as the potential scope should be carefully assessed. Finally, the specificities of clearing and settlement arrangements of derivatives markets should be taken into account. We look forward to continue our discussions with the rest of the industry and the public authorities.

We hope that you find our comments useful and we look forward to an interesting meeting with you and your team next week.

Yours sincerely,

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[5] http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/07/785&format=HTML&aged=0&language=EN&guiLanguag