

Mr. Jacques de Larosière, Chairman
The High Level Group on Cross-border Financial Supervision¹
c/o Mr. David Wright
Deputy Director-General for the Internal Market and Services
European Commission
Brussels

Brussels, 30 January 2009

Subject: Submission to the High Level Group on Cross-border Financial Supervision

Dear Mr. de Larosière,

On behalf of the Federation of European Securities Exchanges (FESE), which represents the Market Operators of 42 securities exchanges active in equities, bonds, and derivatives in the European Union and Iceland, Norway and Switzerland, we would like to thank you for the opportunity to share with you and the High Level Group that you chair our views concerning the financial crisis and the cross-border supervision and regulation of capital markets in the EU.

The perspective of Europe's Market Operators is naturally aligned with the interests of the EU policymakers with regard to the stability, safety and efficiency of the European capital markets. The involvement and contribution of Market Operators, as well as other infrastructures, issuers and investors, are of crucial importance to the current re-assessment of the EU supervisory and regulatory framework.

The credit crises revealed the need for updating our supervisory tools and addressing certain regulatory gaps exposed by the market turmoil. The annexes to this letter are a summary of our testimony of 21 January and cover the two broad topics of supervision and regulation.

The highlights of our submission are as follows:

SUPERVISION:

- Clearer legislation, supervisory convergence, better industry input and potentially flexible technical measures are some of the **important benefits** that have emerged from the Lamfalussy Process in the securities field. The **overall framework for securities supervision** is sound and we see no need for a structural change in the securities field.
- However, **improvements to the existing framework** are needed in order to achieve the following objectives:
 - A **higher degree of convergence** in the field of EU securities law and a more effective **coordination** between CESR and its members;
 - A stronger CESR endowed with **adequate resources**, better access to **market information** and more effective **internal and external negotiating powers**;
 - More coherent arrangements for the **multi-jurisdictional colleges of supervisors**.
- The path to reaching these broad objectives includes the following steps:
 - CESR should be equipped with a **clearer mandate** and a **streamlined decision-making** procedure leading to clearer and more effective decisions;
 - CESR should achieve **budgetary independence** and be endowed with a **clearer legal status** to boost its role both vis-à-vis its members and vis-à-vis third countries;
 - Changes should also be made to the colleges of supervisors including a **clearer division of labour** via delegation of tasks or designation of a lead supervisor and greater regulatory harmonisation / Level 3 coordination to minimise areas of divergence among all supervisors.

¹ 'High Level Group on financial supervision' set up by the European Commission President José Manuel Barroso and chaired by Mr. Jacques de Larosière.

REGULATION:

- The current crisis originated from the US and specifically from the unregulated part of the market, i.e. structured products and over-the-counter (OTC) derivatives. The instruments at the core of the crisis, in particular OTC products, are subject to a lighter regulatory regime in the EU compared to rules applying to Regulated Markets (RMs) in general and cash equities (shares) in particular. Due to the interconnection of the markets, the distress in the unregulated space spread to the regulated space and impacted heavily on the stability of European markets and economy.
- In order to improve the functioning of the financial system as a whole and to reduce future systemic risks, the following three broad actions should be considered in relation to EU regulation:
 - **Providing the market with proper incentives to use safer instruments and venues:** Policymakers should ensure a level playing field between the regulatory treatments of on-exchange instruments compared to OTC instruments by closing unjustified regulatory gaps that unduly incentivise the market to hold OTC instruments and to choose private market structures.
 - **Addressing the risks of the unregulated space:** Policymakers should improve the transparency and encourage the standardisation of OTC products. In order to mitigate the risks of OTC derivatives, counterparty risk management should be improved, in particular by making CCP clearing possible in OTC markets.
 - **Re-building investor confidence and protection:** Investor confidence and investor protection should be at the core of the Commission's and CESR's initiatives going forward. This requires a more inclusive consultation process and a stronger representation of investors' interests as well as re-assessing the effectiveness of investor protection rules such as conflicts of interest.

Please refer to the annexes attached for a more articulated explanation of the considerations summarised above.

Let me conclude by saying that I very much appreciated your invitation to speak before the High Level Group. Our Members look forward to your final proposals which should contribute to greater financial stability and improved functioning of our supervisory and regulatory arrangements.

Yours sincerely,



Judith Hardt

Secretary General

Attachments:

Annex I: The Future of European Financial Markets Supervision

Annex II: The Future of European Financial Markets Regulation

Annex I: THE FUTURE OF EUROPEAN FINANCIAL MARKETS SUPERVISION

Submission to the High Level Group²

FESE represents the interests of the European **Market Operators**. In its Testimony before the High Level Group on 21st January 2009, FESE presented its views on the EU **supervision and regulation** of the securities sector from the perspective of the Market Operators, whose perspective is strongly aligned with the interests of the EU policymakers in the stability, safety and efficiency of the capital markets in Europe. FESE members' primary objective in the current exercise is to contribute to solutions that will re-build **investor confidence**, increase the **transparency of markets** and enhance the operation of **orderly trading and post trading arrangements**.

FESE sees important benefits that have emerged from the Lamfalussy Process in the securities field, such as clearer legislation, supervisory convergence, better industry input and potentially flexible technical measures. The overall framework for securities supervision, where proximity to the market is especially important, is sound. There is no need for a structural change in the securities field that would replace the decentralised framework with a centralised one. However, there are a certain important shortcomings in the existing supervisory structure for securities:

1. In some areas of EU securities law where CESR has played a role, we have **not achieved a sufficient degree of convergence** (either because CESR's Level 3 work did not go far enough, or was not applied consistently by CESR members).
2. Certain other areas where CESR has not played any Level 3 role have suffered from **a lack of coordination** leading to *ad hoc* supervisory responses, especially during the crisis.
3. Certain technical initiatives of CESR at Level 3 suffered **from insufficient in-house know-how and resources**.
4. The **European colleges that exist for multi-jurisdictional exchanges** are well-performing but **could be made more effective**.
5. The external and internal negotiating power of CESR is compromised by its **uncertain legal status and lack of budgetary independence**.
6. Last but certainly not least, the **fragmentation of information** because of the lack of resources and know-how (e.g. MiFID database) also limits the ability of CESR to have a full picture of the market (e.g. they have no access to OTC data); this leads to **greater risks for the stability of the system as whole**.

To address these shortcomings, we recommend the following actions to be considered:

- **CESR should be endowed with a clearer mandate, an increased and more independent budget and a decision-making procedure that leads to clearer decisions.** The possibility of turning CESR into a Community agency – and therefore endowing it with its own legal personality - could be explored. **CESR should be bolder in its focus on enforcement** by initiating Level 3 work in all areas that pose a problem for the Single Market and by reaching clear agreements among its members. CESR should have **the resources to tackle technical and complex subjects**.
- The **European colleges that exist for multi-jurisdictional exchanges should be made more effective, especially through:** a clearer division of labour via delegation of tasks (or designation of a lead supervisor) and more regulatory harmonisation / Level 3 coordination to minimise areas of divergence. Moreover, the principle of subsidiarity applies to colleges as well: A multi-jurisdictional college should not become an additional layer, but simply a mechanism for a coherent approach among the various national authorities involved.
- To boost the EU's role vis-à-vis 3rd countries, the greater cohesion of enforcement in Europe should be accompanied by establishing **a clear regulatory and supervisory regime for 3rd country issuers and institutions**. Moreover, **the Level 3 committees should be allowed a stronger role at the international level**.
- In addition to building its capability for information needed for effective oversight of markets, CESR should **re-build confidence in markets through a greater focus on investor protection**. Consultations should reflect **the full spectrum of diverse interests of the securities value chain** including in particular issuers, shareholders, and investors of different sizes. Consideration should be given to a whistleblower regime similar to the suspicious transaction disclosure rule under the Market Abuse Directive.

² 'High Level Group on financial supervision' set up by the European Commission President José Manuel Barroso and chaired by Mr. Jacques de Larosière.

CONCLUSION

As the Market Operators of Europe, FESE Members recommend that the ideas put forward here be incorporated in the Report of the High Level Expert Group on EU Financial Supervision and taken up by the European Commission in its upcoming policy proposals for the future of the supervision of EU financial markets.

Annex II: THE FUTURE OF EUROPEAN FINANCIAL MARKETS REGULATION

Submission to the High Level Group³

FESE represents the interests of the European **Market Operators**. In its Testimony before the High Level Group on 21st January 2009, FESE presented its views on the EU **supervision and regulation** of the securities sector from the perspective of the Market Operators, whose perspective is strongly aligned with the interests of the EU policymakers in the stability, safety and efficiency of the capital markets in Europe. FESE members' primary objective in the current exercise is to contribute to solutions that will re-build **investor confidence**, increase the **transparency of markets** and enhance the operation of **orderly trading and post trading arrangements**.

INTRODUCTION

The current crisis originated from the US and specifically from the unregulated part of the market, **i.e. structured products and Over-The-Counter (OTC) derivatives that were issued mostly in the US with lighter or no product disclosure and traded on an OTC basis without trade transparency or counterparty clearing**. A high number of European firms which had invested in these instruments were affected by the crisis in their different roles.

Analysing the current EU framework and deciding which of the rules might be at fault for the crisis (or which changes could be helpful in preventing or mitigating future problems) is a difficult task with some caveats. However, it is very clear that **the instruments at the core of the crisis, in particular OTC products, are subject to a lighter regulatory regime in the EU compared to rules applying to Regulated Markets (RMs) in general and cash equities in particular**.

This document analyses these differences in **regulation**, as well as the differences in **market structures**, and their impact on the **level playing field** between regulated and unregulated markets/instruments, **systemic stability**, **safety**, **investor confidence** in markets in general and in the **Internal Market** in particular, drawing conclusions for future policy actions.

HOW DIFFERENTLY ARE THE INSTRUMENTS/VENUES ASSOCIATED WITH THE CRISIS TREATED BY THE EU FRAMEWORK?

- In the EU regulatory framework, many of these instruments in question are exempt from **initial and ongoing product disclosure** requirements because they are not admitted to trading on a RM or are altogether exempted from such regulation, as is the case of Asset-Backed Commercial Paper (ABCP) and Credit Default Swaps (CDS).
- In an attempt to address the risks of some of the products, all derivative products and products that embed a derivative are included in the list of so-called 'complex instruments', which cannot be invested in without at least an appropriateness test being conducted by an intermediary. However, this requirement does not make any distinction between **on-exchange and OTC derivatives**.
- Products such as ABS, ABCP and CDS are subject to MiFID's **best execution requirement**. However, as all non-equity instruments, they are exempted from **pre- and post-trade transparency**.
- OTC financial instruments are also exempted from the **market abuse rules** (unless the underlying is admitted to trading on a RM). Moreover, with the exception of two jurisdictions (Ireland and the UK), MiFID's **transaction reporting rules**, which are supposed to give the supervisors an ability to detect market abuse and prevent the emergence of undue risk build-up, are not imposed on any OTC financial instruments.

The **attachment** to this document provides an overview of these requirements as they apply to different instruments and venues.

In each of these cases, the policymakers would need to determine whether the absence of regulation leads to problems and if so identify a suitable policy response.

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THE IMPORTANCE OF MARKET STRUCTURE

The crisis revealed **the importance of the market structure and infrastructure surrounding any financial instrument to the safety and stability of the system as a whole**. As OTC products, the instruments at the origin of the crisis (eg CDSs) are **not traded on an organised exchange** and, as a consequence, **not cleared by a central counterparty (CCP)**. OTC derivatives account for 80% of all derivatives. Similarly ABCP are usually not admitted to trading on a RM. Without a neutral, multilateral platform to ensure price formation and no clearing house to address counterparty risk, the market structure for such products is characterised by **limited liquidity** and a **high degree of opacity** even in normal market conditions.

By contrast, European RMs have been by and large outside the origin of the crisis, since it was not their products that caused the crisis. The RMs have even mitigated the crisis by providing an efficient mechanism for asset pricing and opportunities to generate liquidity.

Market Operators of RMs were able to play this role because of unique characteristics of their **market model**. Public markets provide **transparent and reliable price-formation mechanisms**; they have **neutrality** and **independence**; they use **robust and appropriate technology**; they carry out regulatory functions that include **monitoring and surveillance of trading**; and they admit to trading only those securities that comply with **stringent initial and ongoing disclosure requirements** and **accounting and auditing standards** imposed by EU laws (many of which Market Operators have chosen to impose on the MTFs they operate as well).

Furthermore, **the post-trading arrangements of public markets that admit securities and derivatives contain important features that ensure safety**. During the credit crisis, the European post-trading infrastructure proved to be resilient and worked well under extraordinary conditions.

By contrast, the lack of centralised clearing for OTC derivatives has augmented the effects of the crisis. Derivatives have specific clearing arrangements that make them distinct from other markets like equities or fixed income. The difficulties experienced in the off-exchange, unregulated, space for derivatives are now being addressed by the European Commission, which is working on a clearing solution for the CDS market to achieve more effective risk management through wider use of CCP clearing.

WHAT IS THE INTEREST OF MARKET OPERATORS IN THIS REFORM PROCESS?

- **Ensuring Fair Competition**

Market Operators have a strong interest in the **stability, safety and efficiency** of the capital markets in Europe. Market Operators represented by FESE operate RMs and MTFs which provide capital to companies of all sizes in Europe and provide **transparent, neutral, independent, innovative and reliable platforms of trading in financial instruments where issuers and investors can meet and where price discovery can take place**. In order to provide companies and investors with access to public markets, Market Operators need conditions of **fair competition** with other listing and trading venues, i.e. in terms of raising capital (vis-à-vis private placement) and trading (vis-à-vis OTC), and with the instruments associated with such venues.

The **regulatory framework** plays a **critical role** in ensuring the conditions for fair competition, because the rules set for the regulated versus less regulated or not regulated markets determine the **relative attractiveness** of these markets to the **investors, issuers, and intermediaries**.

The current regulatory framework fails to establish such a level playing field both in the area of OTC derivatives, which are closely associated with the crisis, and other areas, such as the OTC trading of listed equity, which is an area that is not directly linked to the crisis but also important for the quality of secondary markets. In fact, more generally, **on-exchange instruments have been disproportionately regulated** compared to other instruments. In recent years, we note the de-listing of companies from public markets because of the costs involved in complying with listing requirements and ongoing transparency requirements.

In all these areas where the private market issuance or trading is unduly encouraged by legislation, public markets are **unfairly disadvantaged in their ability to attract capital to their markets** and thus the system as a whole is **tilted in favour of private markets**, with all its consequences in terms of risks. This is an important concern especially in the context of the crisis.

Therefore, Market Operators support measures that establish a level playing field between instruments and venues, i.e. those that ensure that similar rules apply to all services and activities.

- **Preventing Contagion And Spillover Effects**

Secondly, the users of the public markets operated by Market Operators are directly and indirectly impacted by the risks arising from unregulated markets. As demonstrated by the crisis, **the unregulated part of a market can have grave consequences for the whole system and even for the regulated parts because of contagion effects.** For instance, institutional investors with assets tied up in illiquid unregulated markets started selling off assets in the regulated markets, because the latter remained liquid even during the crisis. Thus the spillover from the OTC markets brought down asset prices and reduced the market capitalisation of publicly traded companies.

Moreover, **the unregulated markets can be used to circumvent certain rules during a crisis** and create **unintended policy consequences.** As an example, quite apart from the question of the lack of coordination in the manner in which the short selling rules were applied during the crisis in Europe, they also treated the trading venues inequitably. Short selling bans were applied to cash equities traded on RMs and MTFs but not to the OTC venues. Furthermore, short selling rules could be circumvented by unregulated instruments (such as CDSs) that fulfil a similar function in the market.

Therefore, Market Operators favour measures to minimise the risks of unregulated markets and to promote the operation of orderly trading and post trading arrangements in the unregulated space.

- **Re-building Investor Confidence in the Single Market in Securities**

Finally, Market Operators are **directly impacted by any loss of investor confidence in capital markets**, which is an essential element of attracting investors to capital markets. Due to contagion effects mentioned above, the immense loss of confidence in capital markets caused by the crisis will inevitably affect the ability of even the public markets to attract investor interest, even though their own instruments and venues are not responsible for the crisis. This has an immediate impact on the issuers listed in our markets as it reduces their overall value and hampers their ability to fund themselves publicly.

Moreover, if investors believe that the policies used to safeguard interests which are mostly based on competition do not lead to an effective protection of their interests, this could fuel protectionist feelings within Europe and undermine **competition.** In addition, as Europe's Market Operators are dependent on pan-European investors and issuers, they are directly concerned by the **potential of a loss of confidence in cross-border investments and ultimately in the Single Market** which could ensue from the crisis due to investors losing their cross-border savings or deposits.

Therefore, Market Operators support closing regulatory loopholes in the form of unjustified differential treatment to re-inject confidence in the system and establish truly effective investor protection across all asset classes.

RECOMMENDATIONS FOR FUTURE POLICY

Based on the concerns laid out above, we believe that the following actions should be considered in relation to future EU regulation:

- **Providing the market with proper incentives to use safer instruments and venues**

- The marketplace can find the **optimal balance** between different market structures and instruments **only if** the regulatory treatment of different venues and instruments reflects their differences in safety. Policymakers should ensure a level playing field between the regulatory treatments of **on-exchange instruments** compared to **OTC instruments** by closing current **unjustified regulatory gaps** that unduly incentivise the market to hold OTC instruments and to choose private market structures. Differences in the treatment of on-exchange and OTC products in areas such as **product transparency, trading transparency** and **transaction reporting** should be reassessed.
- Policymakers should provide regulatory incentives in upcoming regulations **to encourage intermediaries to choose public markets** that provide greater **liquidity and safety** because of **organised transparency, neutrality, independence, surveillance and counterparty risk management.**
- In the interest of the market as a whole, there also needs to be a level playing field **in trading surveillance** in order to ensure that markets remain orderly. RMs and MTFs operated by Market Operators have a high level of trading surveillance, whereas it appears that this is not necessarily the same for some new entrants.
- Regulators should revisit **buy-side restrictions** to ensure that they differentiate appropriately between low and high risks of products within each asset class depending on type of issuance and disclosure regime applicable to venue.

➤ **Addressing the risks of the unregulated space**

- As a complement to making sure that the OTC space is not unduly preferred, policymakers should **improve the safety of OTC instruments and venues**. The **transparency of products** that are traded in OTC markets should be increased in order to help the investors assess the risks of these products better.
- Policymakers should encourage the **standardisation of OTC products** to facilitate the **organised trading and clearing** of these products as this will enhance the safety and efficiency of these markets.
- In order to mitigate the risks of OTC derivatives, counterparty risk management should be improved, in particular by **making CCP clearing possible in OTC markets**.

➤ **Re-building investor confidence and protection**

- **Investor confidence and investor protection** should be at the core of the Commission's and CESR's initiatives going forward. This requires a more inclusive consultation process and a stronger representation of investors' interests in any of the regulatory assessments that will be carried out in the future.
- **Conduct of business rules** should ensure effective protection of investors and be well enforced.
- In relation to **conflicts of interests**, the over-reliance of regulation on the methods of **disclosure** and **management**, as opposed to **prevention**, must be revisited.

CONCLUSION

As the Market Operators of Europe, FESE Members recommend that the ideas put forward here be incorporated in the Report of the High Level Expert Group on EU Financial Supervision and taken up by the European Commission in its upcoming policy proposals for the future of the regulation of EU financial markets.

Attachment to Annex II: COMPARISON OF EU REGULATORY TREATMENT AND MARKET STRUCTURES OF VENUES AND INSTRUMENTS

Respective EU law applies Law applies partially Exempt from respective law	EQUITIES			BONDS and OTHER SECURITISED DEBT			DERIVATIVES			
Venue where admitted to trading	Regulated Market, Multilateral Trading Facility, Private Placement			RM, MTF, PP			RM (20%); OTC (80%)			
Venue where traded	RM, MTF, Systematic Internaliser, Over-the-Counter			<ul style="list-style-type: none"> Fixed income, Asset-backed Securities: RM, MTF, OTC Asset-backed Commercial Paper: OTC 			RM, MTF, SI, OTC			
ISSUANCE and ONGOING DISCLOSURE REQUIREMENTS	RMs / IPOs YES	MTFs (National rules – in practice similar to RMs)	PP NO	RMs / IPOs YES	MTFs (National rules, similar to RMs)	PP NO (ABCPs excluded by definition)	Securitised derivatives (certificates, warrants) admitted to RM: YES Non-securitised derivatives on RM: Publicly available contract information	OTC: NO (Bilateral information available only) (CDSs excluded by definition from PD/TOD)		
MARKET ABUSE	RMs YES	MTFs (National rules, similar to RMs)	PP NO	RMs YES	MTFs (National rules, similar to RMs)	PP NO	If instrument or its underlying admitted to trading on a RM: YES	OTC derivatives with no underlying admitted to RM: NO		
INTERMEDIATION RULES	RM: ➤ Investment advice ➤ Appropriateness test ➤ Execution only		Not admitted to RM: ➤ Investment advice ➤ Appropriateness test		Excluding those bonds or securitised debt that embed a derivative ➤ Investment advice ➤ Appropriateness test ➤ Execution only		Those that embed a derivative ➤ Investment advice ➤ Appropriateness test		All derivatives deemed to be ‘complex’ ➤ Investment advice ➤ Appropriateness test	
PRE-TRADE TRANSPARENCY	RM YES	MTF YES/NO	SI YES/NO	OTC NO	NO (except use of Recital 46 by France, Germany, Italy, Poland, Romania and Sweden)			On-exchange: Transparency to the public automatically provided by exchange; full intra-day risk transparency provided by CCP OTC: Limited varying bilateral transparency; no risk transparency		
POST-TRADE TRANSPARENCY (Obligation to report: MAX 3 MIN with deferred publication where allowed)	RM, MTF, SI, OTC YES			NO (except use of Recital 46 by Denmark, France, Germany, Italy, Poland, Romania and Sweden)			On-exchange: Transparency to the public automatically provided by exchange OTC: Limited varying bilateral transparency			
BEST EXECUTION	YES (Differential application for investor)			YES (Differential application for market structure/instrument)			YES (Differential application for market structure/instrument)			
TRANSACTION REPORTING (Obligation to report MAX 24 hrs) (for Investment Firms) REFERENCE DATA (for RMs)	Admitted to trading on RM YES	Not admitted to trading on RM NO		Admitted to trading on RM YES	Not admitted to trading on RM NO		Instrument admitted to trading on RM YES	Not admitted to trading on RM NO		
POST-TRADING MARKET STRUCTURE	RM / MTF CSD and CCP arrangements		OTC NO CCP arrangements		RM / MTF CSD and CCP arrangements		OTC NO	RM CCP arrangements	OTC mostly traded with no CCP	