31st August 2009

FESE Response to the European Commission Consultation 'Enhancing The Resilience Of OTC Derivatives Markets'

A. INTRODUCTION

The Federation of European Securities Exchanges (FESE) represents the Market Operators of 42 securities exchanges active in equities, bonds, and derivatives in the European Union (EU) and Iceland, Norway and Switzerland.

FESE welcomes the opportunity to comment on the European Commission Consultation 'Enhancing the resilience of OTC derivatives markets'. FESE fully supports the Commissions' work in identifying the necessary steps required to enhance the resilience of the OTC derivatives markets.

Our members active in the derivatives field will respond to the questions raised in the Consultation in detail. In the current response, we will provide remarks on **key guiding principles most relevant to exchanges** which we hope will guide the EU in its policy considerations.

B. KEY GUIDING PRINCIPLES

For many decades, derivatives of various kinds have played a very **positive role** in the world economy. We firmly believe that any policy initiatives taken to address market deficiencies unveiled by the financial crisis should target improving the **safety and integrity of derivatives** trading and clearing while maintaining their **positive contribution** to the economy and the financial sector.

FESE members play an important role in derivatives; they operate well-regulated, transparent, technologically advanced trading (and in some cases clearing) arrangements with a proven value proposition and track record in safety and reliability. The positions taken by FESE in this dossier are therefore influenced above all by the derivatives exchanges' wish to maintain the highest standards of **safety and integrity, as well as efficiency and competitiveness,** in the trading of derivatives in a global marketplace.

With regards to **clearing**, we strongly believe that **centralised clearing through a CCP** mitigates counterparty risk, increases liquidity, allows for sound margining and risk control requirements over clearing house members, increases transparency on open risk positions and provides records on OTC derivative transactions. In addition, we stress that **trading** via regulated exchanges cleared into central counterparties offers even greater risk reduction benefits, particularly in terms of increased liquidity.

Importantly, standardisation alone should not determine if a derivatives product can be centrally cleared, although FESE members believe that standardised products are most suited to CCP clearing. Standardisation is only one of the elements that CCPs take into account when deciding whether a product is clearable. Hence, the decision on which products are centrally clearable should be left to clearing houses and their risk management committees and any such decision by an individual clearing house should not result in an automatic mandate for all clearing houses to clear such form of product.

With regards to standardisation, we agree that **standardisation, both of contracts and processes, should be encouraged to the greatest extent possible** and note that the industry has already committed to working toward this goal[1]. Such work should be accompanied and incentivised by regulatory and supervisory support in order to enable both timely and effective progress. We acknowledge, however, that there continues to be **a role for customised OTC derivative products** for risk reduction for clients and that **standardisation will not be possible in every case**.

In some cases, standardisation will **enable the shift of OTC derivatives onto regulated markets**, thus providing to the OTC derivatives space the improvements that the Commission requests to safety and integrity and that regulated markets already provide.

In terms of **encouraging CCP clearing**, FESE members believe that it is legitimate to apply lower capital charges to CCP cleared products to reflect the reduced risk implied. In cases where CCP clearing is not possible due to lack of standardisation or price information, **risk management capabilities** should be enhanced, for example through at least **bilateral netting** and **collateralisation of open risk positions by third-party agents**. This would ensure that gross risk is reduced as far as possible and remaining open risks are collateralised. However, in order to maximise the safety and integrity of markets, no advantage should be granted to **bilateral collateralisation** when central clearing is possible. Collateral management should therefore not be left to non-regulatory initiatives. In addition, FESE members believe that the representation of bilateral collateralisation as a form of clearing is inaccurate and misleading, and likely to impede progress towards the most effective form of risk mitigation.

FESE members support the Commission's intention to enhance market integrity through increased CCP clearing of OTC derivatives. This would ideally be achieved through market led solutions. However, where this proves not possible or effective, mandatory solutions could be put in place. FESE further considers that objective risk assessment of CCP and non-CCP activity and resulting differences in capital treatment are the best means for moving towards increased CCP clearing. In addition, FESE members believe that trading via regulated exchanges cleared into central counterparties offers even greater risk reduction benefits, particularly in terms of increased liquidity, and capital treatment should also reflect this.

With regard to data repositories, indeed this function is important and registration of contracts should be mandatory. It should be considered, however, that **central data repositories** would not be necessary for those instruments that are subject to the transparency and risk mitigation offered by a CCP. CCPs already provide registration and repository functionalities for the products and markets they are clearing. Establishing a central data repository for these instruments would unnecessarily duplicate investment and information. Should the establishment of central data repositories be considered for those instruments not cleared through a CCP, the functions and objectives of the repositories should be clarified. It should be noted that a single repository for all products may not be the most efficient or flexible approach, and different repositories may be suitable for different product types. In addition, FESE notes that such central data repository should be subject to EU law and supervised by EU regulators given the important role of such a repository in the derivatives market structure.

As for the possibility of extending MiFID-type **pre- and post-trade transparency rules to non-equity products,** we wish to note that pre and post-trade transparency for all products listed, irrespective of

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1 See US industry commitment via letter of the International Swaps and Derivatives Association of 2nd June 2009 to the President of the Federal Reserve Bank of New York available at http://www.isda.org/c_and_a/pdf/060209letter.pdf

See letters of commitment to European Commissioner Charlie McCreevy of 17th June of:

- European Banking Federation at http://www.ebf-fbe.eu/DocShareNoFrame/Docs/2/DJPNGPHBIDLMLPNAPFNHFJOMBDTY9YBD73ML5THD5B9L/EBF/docs/DLS/0072-2009-McCreevy-EBF_Commitment_letter_towards_CDS_clearing_in_Europe_-_final-2009-00266-01-E.pdf

- International Swaps and Derivatives Association at http://www.isda.org/speeches/pdf/Commissioner-McCreevy-commitment.pdf whether they are equity or non-equity products, is already provided by regulated markets, and irrespective of whether their rules provide for trading by electronic, open outcry or telephone means. Regulated Markets maintain historical databases of bid, offer and traded prices throughout the trading day. More generally, while we agree that a certain level of transparency promotes efficient and well functioning markets, we do not think that transparency only **reduces volatility or the cost of credit protection.** On the contrary, in some circumstances, adequate transparency on market risks may lead to a more realistic and therefore increased cost of credit protection.

Finally, FESE views **transaction reporting** as a valuable tool of MiFID's objective of ensuring market integrity and preventing market abuse in EU equity markets, but is unconvinced that transaction reports are equally appropriate for all other instruments, particularly for, e.g. OTC derivatives or exchange-traded **commodity derivatives.** Indeed, the MiFID regime already needed to be substantially adapted to on-exchange derivatives (other than commodities, which were subject to a transitional regime).[2] For standardised exchange-traded commodity derivatives contracts requiring delivery, transaction reporting has no merit when it comes to identifying potential market abuses such as squeezes.

With these broad objectives in mind, any EU initiatives in this area should recognise that **the market for derivatives is global.** FESE believes that any potential intervention by the EU targeting European derivatives markets should be designed in such a way that it does not have any negative effects on the competitiveness of European derivatives markets vis-à-vis non-EU jurisdictions. International coordination is essential to ensure a level playing field across those jurisdictions with derivatives' business.

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[2] Negotiations with CESR led by FESE resulted in an Alternative Instrument Identifier (AII) (consisting of a subset of the fields described in Annex 1) which is being used to identify securities derivatives in those markets and contracts where identifying instruments to the level of detail required (i.e. at series/settlement level) could not be achieved in a practicable manner using ISIN codes.

ANNEX I - The Alternative Instrument Identifier (AII)

Exchange Code – this is the four character MIC code of the regulated market that admits the derivative to trading. This element of the code is described in field 21 (venue identification) of Annex 1 of the MiFID level II text.

Exchange Product Code – this is a code maintained by the derivative exchanges and is freely and generally available to all parties. It is between one and 12 characters in length and is uniquely associated with a particular underlying instrument and settlement type and other characteristics of the contract. This element of the code is described in field 6 of Annex 1. This proposal will necessitate use of Instrument Code Type (field 7). The regulated markets will supply the reference data, including underlying ISIN, that are uniquely associated with the combination of MIC and exchange product code.

Derivative Type – This is a single character field identifying whether the instrument is an option or a future. This element of the code is described in field 12 of Annex 1.

Put/Call Identifier – This is a single character field identifying whether the option (if it is an option) is a put or a call. This element of the code is described in field 13 of Annex 1.

Expiry/Delivery/Prompt Date – This element of the code is described in field 11 of Annex 1.

Strike Price – This element of the code is described in field 14 of Annex 1.

These elements are used instead of an ISIN code to identify an instrument in transaction reports and they collectively constitute the Alternative Instrument Identifier for an instrument.

The reference format for the Alternative Instrument Identifier is the following:

Data element	Maximum length	Format
Exchange Code	4 characters	Will always be 4 characters (ISO MIC code)
Exchange Product Code	12 characters	Up to 12 alphanumeric chars, no space padding
Derivative Type	1 character	Always 1 alpha character
Put/Call Identifier	1 character	Always 1 alpha character
Expiry/Delivery/Prompt Date	YYYY-MM-DD	Always 10 alphanum chars (including separators), conforms to ISO 8601
Strike Price	19 characters	Up to 19 numeric characters including up to five decimals with a point (ASCII character 46) as the decimal separator and without any leading or training zeros