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RESPONSE OF THE FEDERATION OF EUROPEAN SECURITIES EXCHANGES (FESE)
PUBLIC CONSULTATION ON DERIVATIVES AND MARKET INFRASTRUCTURES

I. Introduction

The Federation of European Securities Exchanges (FESE) represents 45 exchanges in equities, bonds, derivatives and commodities through 20 full members from 29 countries, as well as 7 Corresponding Members from European emerging markets.

Our response below is structured according to the different sections included in the consultation paper and the questions suggested in each of them. We have also included a brief section with some general remarks.

II. GENERAL REMARKS

FESE welcomes the opportunity to contribute to this public consultation on 'derivatives and market infrastructures' which, as explained in its introduction, results from the problems identified in the OTC derivatives markets and follows the mandate of the G20 leaders' statement agreed on 25th September 2009. In addition to our responses to the different questions outlined below, we would like to note the following:

- This consultation covers CCP clearing of OTC derivatives, one part of the mandate of the G20 mandate. Other upcoming legislative proposals of the European Commission should cover the rest of the G20 mandate, including trading of OTC derivatives on organised venues. We consider that trying to meet this mandate through separate legislative proposals may produce unintended consequences and eventually put at risk the implementation of the G20 agreement by end-2012 at the latest.

- The consultation deals with the subject of interoperability in cash equity markets, which is totally unrelated to the financial crisis and was not discussed by the G20 leaders. As explained below, in order to meet G20 commitments on time, the Commission should focus the upcoming legislative proposal on the implementation of the G20 mandate. Interoperability for cash equity deserves a separate debate and an appropriate impact assessment. This would be particularly important at a time when security is the priority of financial markets. A badly designed interoperability framework could put this at risk.

- We also note that the consultation suggests an important role for the future European Securities Markets Authority (ESMA). FESE believes that most of the Commission proposals in this regard are sensible. However, we encourage the Commission to take into account the current discussions about the future of the supervisory authorities in Europe, whose result will impact the future legislative proposals of the Commission.

III. FESE RESPONSE TO PUBLIC CONSULTATION ON DERIVATIVES AND MARKET INFRASTRUCTURES

Section I - CLEARING AND RISK MITIGATION OF OTC DERIVATIVES

1. Clearing obligation

2. Eligibility for the clearing obligation

3. Access to a CCP

What are stakeholders' views on the clearing obligation, the process to determine the eligibility of OTC derivate contracts for mandatory clearing, and its application? Do stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?

FESE believes that a combination of the two approaches included in the consultation, top-down and bottom-up, would represent a good benchmark to determine the eligibility of OTC derivative contracts for mandatory clearing. We agree that CCPs should play a key role in the eligibility process, both in the bottom-up approach, by initiating the process of deciding to clear certain contracts, as well as in the top-down approach, in which CCPs would need to be consulted. The decision on which products are centrally clearable should be left to clearing houses 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. The role of ESMA in the eligibility of the clearing obligation would be useful in this sense.

We also note that the European Parliament supports the European Commission proposal for mandatory clearing, as the European Parliament resolution drafted by MEP Werner Langen and adopted by the European Parliament in June 2010[1] 'backs the call for the compulsory introduction of CCP clearing between financial institutions for all eligible derivative products with a view to ensuring better assessment of counterparty credit risk'.

Access to a CCP

Access by market participants to the CCP should be ensured based on participation requirements at CCP level.

In order to be consistent with the G20 mandate and the introductory comments of Section I of the consultation, we suggest clarifying that the authorisation referred to in section I.3 refers to eligible '**OTC'** derivative contracts.

4. Non-financial undertakings

Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?

While the details of the information and clearing thresholds suggested in the consultation are unclear, we consider that it is sensible to have a system of thresholds for non-financial institutions, provided they are subject to reporting and transparency requirements. This would ensure that all those transactions that could be considered as important from a systemic risk point of view would be subject to the CCP clearing obligation suggested for financial institutions. In addition, the threshold system would prevent legislative arbitrage between different users of derivatives products.

We are glad to note that a similar threshold approach has been suggested by the European Parliament in its resolution on derivatives of June 2010[2].

[1] European Parliament resolution of 15 June 2010 on derivatives markets: future policy actions (2010/2008(INI))

[2] European Parliament resolution of 15 June 2010 on derivatives markets: future policy actions (2010/2008(INI))

5. Risk mitigation techniques for non-cleared contracts

Do stakeholders share the principle and requirements set out above on the risk mitigation techniques for bilateral OTC derivative contracts?

FESE agrees that in cases where CCP clearing is not possible, risk management capabilities should be enhanced, for example through at least bilateral netting and collateralisation of open risk positions by third-party agents. These bilateral risk management procedures must be subject to adequate capital requirements.

Section II - REQUIREMENTS FOR CENTRAL COUNTERPARTIES

Do stakeholders share the general approach set out above on organisational requirements for CCPs? In particular comments are sought on the role and function of the Risk Committee; whether the governance arrangements and the specific requirements are sufficient to prevent and manage potential conflicts of interest; stringent outsourcing requirements; and participation and transparency requirements?

Risk Committees

Risk Committees should have an advisory role. The draft responsibilities for risk committees included in the consultation paper seem to be overly prescriptive and could serve to impede flexibility for each organisation to achieve the optimum solution based on their individual profiles.

FESE members consider that the proposal for a CCP to inform the competent authority of any decision in which it decides not to follow the advice of the risk committee creates an unnecessary obligation. We believe this would not represent a material additional benefit for competent authorities. Any such decision would be monitored by the Board of the CCP on which independent Board members sit. Therefore we suggest that such information would be available to competent authorities via the Board of the CCP.

We agree with the proposal to have a risk committee with independence from operational management of the CCP as well as with the proposal for risk committees to have an advisory role to the CCP. Risk committees should not replace other CCP risk management activities, which are currently undertaken by other bodies within the structure of CCPs.

Outsourcing

The current proposal on outsourcing activities looks satisfactory.

Do stakeholders consider that possible conflicts of interests would justify specific rules on the ownership of CCPs? If so, which kind of rules?

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Do stakeholders share the approach set out above on segregation and portability?

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Do stakeholders share the general approach set out above on prudential requirements for CCPs? In particular: what should be the adequate level of initial capital? Are exposures of CCPs appropriately measured and managed? Should the default fund be mandatory and what risks should it cover? Should the rank of the different lines of defence of a CCP be specified? Will the collateral requirements and investment policy ensure that CCPs will not be exposed to external risks? Will the provisions ensure the correct management of a default situation? Are the provisions above sufficient to ensure access to central bank liquidity without compromising central banks' independence?

We concur with the European Commission that the critical areas described in the context of the prudential requirements are the backbone of the safety of CCPs and, ultimately, financial stability. Based on the experience of FESE members in managing CCPs, we believe that although legislation should be detailed enough for ESMA's technical guidance to be as effective as possible and we welcome the possibility of having harmonised standards across Europe, CCPs should retain the ability to determine the lines of defense and their applicability to their business model. CCP should have some flexibility to manage the balance between the default fund and the own resources. However, we do support the need for transparency and clarity on these issues along with certainty for clearing members to enable them to assess their maximum exposure.

We believe that the foreseen 10% cap in credit line arrangements could be difficult to comply with as it is written in the consultation paper. Certain flexibility could be useful in order for CCPs to be able to 'accommodate' this obligation to business model and structure.

In addition, section 8.H (e) leaves no operational option/margin for the CCP to manage liquidity. This paragraph could well be 'absorbed' by 8.H (a).

Do stakeholders share the general approach set out above on the recognition of third country CCPs? Are the suggested criteria sufficient? Do stakeholders consider that additional criteria should be considered?

The general approach on the recognition of third country CCP looks appropriate. In order to ensure an efficient EU regulatory framework, FESE members suggest a single CCP status EU wide to facilitate passporting and third-country recognition.

In the same context, EU regulators should require reciprocity from third-country jurisdictions. When granting access to a third country entity, European regulators should ensure that EU entities get reciprocal access to that third country.

Do stakeholders agree with the extension of the clearing obligation to contracts cleared by third country CCPs to ensure global consistency?

We agree that global consistency is necessary to avoid regulatory arbitrage across jurisdictions. The European Parliament resolution on derivatives[3] underlined the need for the Commission to coordinate its actions with Europe's partners as far as possible as well as the importance of avoiding regulatory arbitrage through inadequate international coordination.

Section III - INTEROPERABILITY

Stakeholders' views are welcomed on the general approach set out above on interoperability and the principles and requirements on managing risks and approval.

FESE members believe that the Commission should focus the upcoming legislative proposal on the implementation of the G20 mandate. Interoperability for cash equity markets deserves a separate debate and an appropriate impact assessment. This would be particularly important at a time when security is the priority of financial markets. A badly designed interoperability framework could put this at risk.

Indeed, FESE believes that certain conditions have to be met for interoperability to work properly and based on the following considerations interoperability should not be mandated through legislation:

[3] European Parliament resolution of 15 June 2010 on derivatives markets: future policy actions (2010/2008(INI))

- **European supervisors need to be involved in the approval and the monitoring of any links to ensure proper risk management –** The crisis has shown how difficult it is to assess counterparty risk and to detect potentially systemic interlinkages across financial institutions in relation to a "too-connected–to-fail" problem[4]. In view of the increasing number of interoperability proposals, a number of European regulators are currently studying the implications of interoperability for the safety and the functioning of European markets. Some of them have indicated that 'the potential benefits that interoperability may bring to the market (…) need to be balanced against the risks introduced by interoperability. Any benefits to the market that may result from interoperability cannot be at the expense of an increase in unmitigated risk to the clearing system. Accordingly, any additional or increased risks identified must be adequately mitigated'[5]. The concerns raised by regulators are legitimate which is why FESE believes that European supervisors should be closely involved in the approval and the monitoring of any links. Indeed, the core function of a CCP is to provide appropriate risk management. Interoperability must therefore fulfill appropriate risk management arrangements.

- **Interoperability must not increase systemic risk or cost** – In response to the financial crisis, the objective of regulators and investors around the world is to ensure safer financial markets. Interoperability of CCPs could potentially increase financial instability because risks could spread across the interoperable links between CCPs. To contain this event during a turbulent market environment, i.e. risks spreading through a chain of CCP interoperability at the weakest point of such chain, regulators may need to consider a significant increase of capital to act as a risk buffer. FESE therefore proposes that the Commission studies the impact of interoperability to ensure that interoperability does not increase systemic risk or cost.

- **Interoperability should not increase the overall trading costs and needs to take into account the business case for the users** – A key condition for the establishment of an interoperability link should be the existence of a clear business case for the users of the CCP, who would be the main beneficiaries of an interoperability arrangement. We believe that users have become less eager to push for more interoperability because of the increasing costs linked to anticipated collateralisation requirements of each new CCP link. For interoperability to be beneficial for investors and the single European market as a whole, the benefits should not be eroded by an increase to the overall costs of trading in Europe.

These concerns need to be assessed and clear benefits identified before the Commission can conclude on the optimal approach for financial markets. Instead of mandating interoperability in the current EMIL legislative proposal, FESE believes that addressing the above concerns through a detailed impact assessment can give clear benefits as it will allow the European Commission to focus on meeting G2O mandate, like the European Parliament has done in its resolution on derivatives[6], and to ensure the reform of OTC derivatives markets is adopted on time in line with the Commission's top priorities for 2010[7] and the European Council provisional conclusions from 9/10 May[8].

[4] See International Monetary Funds' 'Global Financial Stability Report Responding to the Financial Crisis and Measuring Systemic Risks' April 2009 at http://www.imf.org/external/pubs/ft/gfsr/2009/01/ .

[5] Communication of Regulatory Position on Interoperability by AFM, DNB, FINMA, FSA and SNB of February 2010.

[6] European Parliament resolution of 15 June 2010 on derivatives markets: future policy actions (2010/2008(INI))

[7] President Barroso envisaged 'the Commission coming forward with ambitious legislation to regulate derivatives in 2010'Political guidelines for the next Commission', page 21 http://ec.europa.eu/commission_2010-2014/president/pdf/press_20090903_en.pdf

[8] In the main results of the Extraordinary Council meeting on Economic and Financial Affairs in Brussels on 9/10 May 2010, Ministers 'underlined the need to make rapid progress on financial market regulation and supervision, in particular with regard to derivative markets and the role of rating agencies' See http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114324.pdf

Section IV - REPORTING OBLIGATION AND REQUIREMENTS FOR TRADE REPOSITORIES

What are stakeholders' preferred options on the reporting obligation and on how to ensure regulators' access to information with trade repositories? Please explain.

FESE members believe that CCPs already provide registration and repository functionalities for the products and markets they are clearing. Most members believe that establishing a trade repository for these instruments would unnecessarily duplicate investments, information and data storage costs, making the whole CCP clearing process less efficient.

Do stakeholders share the general approach set out above on the requirements for trade repositories? In particular, are the specific requirements on operational reliability, safeguarding and recording and transparency and data availability sufficient to ensure the adequate function of trade repositories and the adequate protection of the data recorded?

A 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.

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