FESE AISBL
Avenue de Cortenbergh, 52 B-1000 Brussels
VAT: BE0878.308.670
Tel.: +32 2 551 01 80 – Fax : +32 2 512 49 05

3rd June 2008

FESE feedback on BIS report "New developments in clearing and settlement arrangements for OTC derivatives"

Introduction

1. The Federation of European Securities Exchanges (FESE) is a not-for-profit international association (AISBL), representing the operators of the European regulated markets and other market segments, comprising the markets for not only stocks and bonds, but also financial, energy and commodity derivatives. Established in 1974 as a small forum of stock exchanges in Europe, FESE today has 24 Full Members representing close to 40 securities exchanges from all the countries of the EU and Iceland, Norway, and Switzerland, as well as several corresponding members from other non-EU countries.

2. The Committee on Payment and Settlement Systems (CPSS) issued a report on 'New developments in clearing and settlement arrangements for OTC derivatives' in March 2007. The report analyses existing arrangements and risk management practices in the broader OTC derivatives market and evaluates the potential for risks to be mitigated by greater use of, and enhancements to, market infrastructure. The report focuses on the risks created by delays in documenting and confirming transactions; the implications of the rapidly expanding use of collateral to mitigate counterparty credit risks; the potential for expanding the use of central counterparty (CCP) clearing to reduce counterparty risks; the implications of OTC derivatives prime brokerage; the risks associated with unauthorised novations of contracts; and the potential for significant market disruptions from the closeout of OTC derivatives transactions following the default of a large market participant.

FESE feedback on BIS report "New developments in clearing and settlement arrangements for OTC derivatives"

3. As a representative of Regulated Markets, FESE welcomes the CPSS report which further encourages efficiency and effectiveness of OTC derivatives trading and post-trade processing. FESE believes that this is particularly appropriate given the fact that regulated markets and OTC markets are not mutually exclusive: users of OTC markets use financial instruments admitted to trading on regulated markets to hedge OTC risk; regulated markets offer access in certain standardised or semi-standardised instruments traded OTC to their novation and clearing facilities; OTC markets are often the genesis for new contracts admitted to trading on regulated markets; and, as has been demonstrated by the recent and continuing credit and confidence crisis that originated in OTC structured products markets, regulated markets are much less negatively impacted by the financial market crisis and instead serve as a stabilizing factor to the whole industry by providing access to neutral liquidity, fair prices and secure as well effective post-trade processing with counterparty risk mitigation.

4. Regulated Markets display a distinctive market structure with the aim of offering transparent price discovery and liquidity for assets admitted to trading on their markets. These attributes result from a number of important principles that exchanges worldwide put into practice:

   - Public markets are **transparent**. Prices are set with all the possible information available through real-time dissemination tools.

- Public markets are **multilateral.** Prices are discovered through the aggregation of the expectations of many investors through their bids and offers (as well as price formation by market makers or liquidity providers) which ensures reliability, a high degree of information as well as liquidity under the most demanding market conditions.
- Public markets are **neutral and independent.** They endeavour to ensure an equal treatment for all participants as well as to provide the set of rules and the IT infrastructure that best serve the interest of all investors.
- Public markets use robust and appropriate **technology**. Public market operators invest significantly in technology to ensure that it is reliable and that it continually advances in anticipation of customer needs, e.g. regarding speed and volume.
- Operators of public markets have regulatory functions that include **monitoring and surveillance of trading**, with RMs having more stringent obligations in this area than operators of MTFs.
- RMs only admit to trading securities issuers that comply with **stringent initial and ongoing disclosure requirements and accounting and auditing standards** imposed by EU laws. When operating MTFs, Market Operators have chosen to impose similarly stringent requirements to ensure the highest level of company disclosure possible for the issuers on these markets.

5. Based on our experience in Regulated Markets, we believe that there is clearly room to **improve the safety and efficiency of OTC derivative markets by addressing some of the issues highlighted in the report.**
   - The report demonstrates that there is room for improving the functioning of global OTC derivatives markets. We believe the users of those markets will benefit from, amongst others, an increase in fee and price transparency, enhancement of liquidity and wider use of efficient clearing and settlement services. In a recent press release, the Federal Reserve Bank of New York refers to the need to improve processing challenges that persist in OTC derivatives markets while applauding initiatives announced by major market participants in the area.[1]
   - An increase of operational efficiency and mitigation of operational risks would help OTC markets approach the high standards of on-exchange derivative markets with regards to safety and efficiency. Under competitive conditions the private sector can deliver appropriate solutions.

6. The CPSS report highlights several areas that FESE agrees should be in focus:
   - **FESE appreciates the efforts in the last decade to extend the use of CCP clearing within the OTC derivatives markets**. We think an extended use of CCP clearing is an important step to manage risk more comprehensively. We are convinced that OTC derivatives markets could greatly benefit from the scalability and efficiency of centralized transaction and processing infrastructures of organized markets and clearinghouses. Rather than investing in redundant new venues and similar services the industry should utilize parts or all of the existent and globally available infrastructure and the transparent risk management processes offered by leading organized markets and clearinghouses. In this context, we fully agree with the report's appraisal that "CCP clearing may also be expanded over time to encompass additional instruments, especially relatively non-complex instruments, or to include tiered clearing arrangements that would allow clearing to extend beyond the inter-dealer market".

     The benefits of CCPs are widely recognised. By imposing itself as the legal counterparty of every trade, a CCP has direct interaction and counterparty risk exposure with each trading party. This gives the CCP the incentive to closely monitor traders, as well as access to the information

[1] Press release "New York Fed Welcomes New Industry Commitments on Credit Derivatives", 27 March 2008, Federal Reserve Bank of New York.

needed to optimally manage risk. Through effective risk management—for example including imposing capital requirements on members, holding collateral from members to cushion against adverse market fluctuations, requiring variation margin to prevent build up of market losses, and using loss-sharing arrangements—CCPs are effective towards the reduction of systemic risks and limit the risk of bilateral transactions between users, ensuring that all obligations between users are met. Furthermore, they ensure operational efficiency by reducing costs for users through the process of netting transactions.

- With regard to the use of collateral **we would like to underline that the optimal allocation/ management and transfer of collateral will reduce risks and costs of participants in the OTC derivatives industry.** The efficient and increased use of non-cash collateral for OTC derivatives will also become easier through a higher level of standardization in communications and collateralization procedures between parties, and/or by the increasing use of collateral agency services as offered by clearinghouses and securities depositories, such as ICSDs and Global Custodians, those services progressively offering possibilities to re-hypothecate securities received as collateral. This will allow for the seamless and effective allocation of collateral to support its efficient use.

- **FESE supports the extension of the CPSS-IOSCO Standards in order to encourage a "functional approach" to regulation.** CPSS-IOSCO Standards for the operational reliability of securities settlement systems and CCPs should be applied to providers of clearing and settlement services for OTC derivatives that are not already subject to those standards. Market-led recommendations from the respective regulatory and industry bodies would be very much appreciate to achieve a coordinated and effective integration of the post-trade processing and risk management operations of OTC and listed derivatives. This would also make the current decentralized and less transparent OTC processing and operations subject to the sound regulatory oversight applied to organized markets and clearinghouses.

Conclusion

7. The BIS report "New developments in clearing and settlement arrangements for OTC derivatives" analyses existing arrangements and risk management practices in the OTC derivatives market and evaluates the potential for risks to be mitigated by greater use of, and enhancements to, market infrastructure. We believe that there is clearly room to improve the safety and efficiency of these markets, and indeed consider this to be essential due to the close inter-relationship between trading on regulated markets and the OTC market. The use of CCP clearing, the optimal allocation/management and transfer of collateral as well as the extension of the CPSS-IOSCO Standards to providers of clearing and settlement services for OTC derivatives would contribute towards the well-functioning of OTC derivatives markets.