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28 August 2009

Submitted to: markt-g2-consultations@ec.europa.eu

Enhancing the resilience of OTC derivatives markets

The London Stock Exchange Group has over 200 years of experience operating well regulated, fair and efficient markets. The London Stock Exchange is Europe's largest and most liquid equity market. Since 2007, Borsa Italiana S.p.A, which operates the Italian equity market, joined the London Stock Exchange Group (the Group). The Group has a majority interest in MTS, Europe's leading market for trading government debt.

As a general principle, trading via a public trading venue increases transparency and efficiency by enabling efficient price formation, and reduces the possibility of price manipulation, as well as facilitating effective risk management. Ultimately, a vibrant, liquid public secondary market is key to ensuring confidence in equity markets and delivering benefits for end investors.

Borsa Italiana S.p.A. operates IDEM, the Italian derivative market and the London Stock Exchange operates EDX London. EDX London is a UK Recognised Investment Exchange and provides for trading and clearing of international derivatives, primarily focusing on Scandinavian and Russian securities. EDX is majority owned by the London Stock Exchange in a joint venture with the TMX Group of Canada. IDEM is the Italian Derivatives Market for equity derivatives. Products listed on the IDEM include: futures, mini-futures and options on the FTSE MIB Index and futures and options on single stocks. IDEM also has a segment named IDEX where futures on electricity are traded.

We welcome the opportunity to respond to the Commission's consultation on possible initiatives to enhance the resilience of OTC derivatives markets.

We agree with the Commission's objective of seeking to strengthen the safety of derivatives markets and assess how risks can be reduced, with a view to ensuring financial stability. As noted above, we believe that transparent public markets facilitate the achievement of this objective as well as assisting in price determination and improving market efficiency. Our detailed responses to the Commission's detailed questions are contained in the Appendix.

In summary:

- we agree that, as far as possible, trading of derivatives via public order books should be encouraged
- we consider that “cleared-only” for suitable products is the next best option, although trading on exchange is still preferable
- however, the Commission needs to be mindful of the potential systemic risks arising from seeking to bring some of the more complex products (notably Credit Default Swaps (CDSs)) on to CCPs and in particular the resulting concentration of risk in key market infrastructure providers.
- we believe that a valuable tool for mitigating risk, which is already available, is to introduce measures which reduce the incidence of failed settlement or disputed contract terms, such as electronic trade confirmation and affirmation services

Suitability of derivatives for public markets

The term derivative encompasses a number of different instruments with different features and constructs, which in turn results in very different risk profiles. Understanding these risks is critical to assessing the sustainability of trading mechanisms and managing systemic risk arising from the trading of such instruments.

For equity derivatives, index derivatives and other non-complex derivatives, the factors that affect the price (such as interest rates and the price of the underlying security) are widely known. The **trading of such instruments on an exchange order book brings important benefits** to the price formation process and overall market efficiency, as recognised by the Commission in its consultation. Exchange order books offer well-regulated, transparent, technologically advanced trading with a track record in safety and reliability. We therefore strongly support the Commission’s encouragement of the channelling of further trade flow through transparent and efficient trading venues.

Whilst these products can be “cleared-only” we believe that this will not deliver the same market benefits as encouraging exchange order book trading, as it would not ensure the integrity of the price formation process. In these circumstances the risk placed upon a CCP is mitigated through margining, collateral and default funds that are calculated on the basis of prices that are relatively reliable and easy to obtain.

In contrast, more complex derivatives such as credit default swaps (CDSs), by their very nature, do not have an effectively functioning market with sufficient liquidity (or a sufficient number of different traders to make those prices relevant) to form consistent, representative, prices. Nor do they have an underlying source from which to reference a price. This makes the ability to obtain a reliable valuation much more difficult. In addition, very often CDSs contain a leverage element that contributes to the increase in systemic risk in the event of the default of the underlying. For the above reasons, these instruments are not currently traded on public order books.

This has led policy makers to view the central clearing of CDSs as the next best option.

Systemic risk considerations

Events have shown that instead of reducing systemic risk by efficiently allocating risks within an economy (as many believed, pre-crisis) - credit risk transfer has actually contributed to a rise in systemic risk. One of the problems was that **risk was not always shifted to the parties that were best able to bear it**. It is important for the stability and reputation of markets that this is not repeated.

We agree with the Commission's view of the benefits of clearing CDSs through a central counterparty (CCP), namely the ability for firms to reduce counterparty credit risk and achieve regulatory capital savings. However, we believe that proper consideration needs to be given to the **systemic risk issues** posed by such an approach.

The CCP will have margins, default funds and other guarantees. However the scale of the potential losses that could be generated by CDS markets (given as USD 41.868 trillion worldwide) makes it imperative that they have access to a sufficiently liquid market in order to be able to close the open position of a defaulting member. If such a market does not exist, they must have sufficient financial resources to be able to absorb the losses deriving from a member's default.

Clearly, failure of a CCP through its exposure to CDSs could have significant ramifications, not only for derivatives markets but also for all markets and trading venues through the effect it would have on confidence in the use of CCPs.

In practice, the interposition of a CCP in CDS transactions means that counterparty risk is concentrated in the clearing house. This risk would be **even greater** if this were to be **concentrated on a single European CCP**, as this would be a **single point of failure**.

The consultation recognises that ESCB-CESR Standards are being developed to look at the safety and soundness of CCPs. We note that the Commission also proposes "providing further regulatory and supervisory assurances that CCPs are safe and sound by means of future European legislation where justified and possibly common supervision". We strongly support the development of appropriate standards and look forward to engaging in debate on these in due course. However, we believe that supervisory responsibility must correspond to fiscal responsibility.

In the meantime, electronic trade confirmation is a way in which risk can be reduced – by reducing the incidence of settlement failure and contract dispute. Much of the current OTC process still relies on multiple versions of faxed documentation, with great scope for error and dispute. We believe it is vital that if contracts are not exchange traded, or cleared (and in any case for end customer legs), then at a bare minimum, there should be a clear record of what has finally been agreed to, with an audit trail from all parties to the trade – ideally electronic.

I hope that you will find our views useful and please do not hesitate to contact me should you have any questions in relation to the above.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'A Collett'. The signature is fluid and cursive, with the first letter 'A' being particularly large and stylized.

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APPENDIX

Full list of CP questions

Standardisation

Q1 – Q4: We support the policy makers' effort to promote further standardisation of the contractual parameters and standardisation of the contracts themselves, considering that only standardised products can be traded on public trading venues and cleared through CCPs.

One area where we believe that improvements could be made to the functioning of the derivatives market is electronic **confirmation and affirmation services**.

Currently, a large proportion of trade confirmations are communicated using fax machines. This is inefficient and outdated – firms have told us that trade confirmations often do not get positively affirmed and a high proportion of those trades then result in settlement failure. This failure - which increases risk and cost to market participants and reduces market efficiency - could be avoided. There are far more efficient ways of providing confirmation and positive affirmation of a trade, such as web-based systems which are fast, direct, easy to use, and would deliver greater certainty.

For this reason, we believe that broker dealers should be required to receive positive affirmation from their clients for all OTC derivatives trades. For smaller firms that do not want to invest in costly infrastructure, a variety of web-based solutions requiring no implementation are available. Should firms choose to implement other solutions, we believe that the reduced risk and reduced incidence of settlement failure would mean that the cost would pay for itself over time.

There are a number of these products available, including the Groups' own offering - UnaVista - which is a web-based matching, reconciliation and data integration engine providing quick and reliable access to a consolidated data hub. UnaVista is hosted at the Exchange, and allows companies to implement exception management workflows quickly and flexibly and securely, without requiring any hardware deployment.

Strengthening bilateral collateral management

Q5 – Q8: The Group is not best placed to answer these questions.

Central data repository

Q9 – Q11: The Group believes it is important for regulators to have access to more information regarding derivatives markets and in particular that they are able to build a clear understanding of the size of the market, the number of transactions and the size of outstanding positions. We therefore support the use of a central data repository as regulatory tool, but we believe that it is not necessary for those instruments which are subject to the transparency provided by a CCP. The Commission should also consider the extent to which this is necessary if information

is made more readily accessible under increased transparency requirements (see response to Q21-Q23 below).

CCP clearing

Q12: Do you agree that the eligibility of contracts should be left to CCPs? Which governance arrangements might be necessary for this decision to be left to the CCPs' risk committees?

Yes, CCPs are best placed to determine which contracts they are ready and willing to clear, based on their risk management framework.

Q13 – Q14: These questions are best answered by firms.

Q15: Should additional requirements, such as appropriate account segregation, be introduced to apply the zero-risk weighting to indirect participants?

We believe that account segregation by CCPs is useful from a number of perspectives. The consultation mentions one - the ability to apply the zero-risk weighting to indirect participants. This also allows clearing houses to manage risk and allows timely management of issues, which makes management of defaults much easier. We are therefore in favour of introducing a requirement for CCPs to have segregation of the firms' proprietary accounts from its third party client accounts.

Q16 – Q18: Should bilateral clearing of CCP-eligible CDS be penalised and, if so, to what extent? Is there a need to extend regulatory incentives to clear through a CCP to other derivatives products?

Firms will use their own risk management procedures to determine how they operate. The risk weighting of products will be a determinant in how they trade and clear derivatives contracts. As explained above, we believe there are strong benefits that can be obtained through trading on a public venue and clearing through a CCP for many products. Regulatory risk weighting could therefore be useful in encouraging firms to trade on public venues and clear via a CCP as much as possible.

However, given our concerns regarding the clearing of, for example, CDSs via a CCP (as explained above), we do not believe that it is advisable to use regulatory penalties to achieve this particular aim.

Q19: What statistics need to be provided to regulators to make sure they have all the information necessary to perform their duties?

We believe that enhanced transparency requirements for derivatives will provide essential information to regulators to enable them to produce the statistics they need to perform their duties.

Q20: How could European legislation help ensuring safety, soundness and a level playing field between CCPs?

As mentioned above, we believe that the Commission needs to pay due attention to the risks that might be created by CCPs clearing products such as CDSs, for which obtaining a reliable valuation is difficult.

Our concern lies with the ramifications that failure of a CCP through its exposure to CDSs could have, not only on derivatives markets but also on all markets and trading venues. For example, equity markets also use CCPs, thus the failure of a CCP could have direct implications, not to mention the impact it would have on confidence in the use of CCPs more widely.

The creation of a CCP means that counterparty risk is concentrated in the clearing house. The CCP will have margins, guarantees and a default fund, but the scale of the potential losses that could be generated by CDS markets (given as USD 41.868 trillion worldwide) means that they must also have sufficient capitalisation to be able to absorb the losses deriving from a member's default.

The inherent risk of products such as CDSs means that proper consideration needs to be given to the **systemic risk issues** posed by CCP clearing. A CCP that is undertaking CDS clearing may need an additional public backing, such as a government guarantee and lender of last resort facility, in order to be considered fully creditworthy. Further, we believe that the systemic risk associated with CDS clearing is even greater if this risk is **concentrated on a single European CCP**, as this would be a single point of failure.

The consultation recognises that ESCB-CESR Standards are being developed to look at the safety and soundness of CCPs. We note that the Commission also proposes "providing further regulatory and supervisory assurances that CCPs are safe and sound by means of future European legislation where justified and possibly common supervision". We strongly support the development of appropriate standards and look forward to engaging in debate on these in due course. However, we believe that supervisory responsibility must correspond to fiscal responsibility.

Transparency requirements

Q21: Should MiFID-type pre- and post-trade transparency rules be extended to non-equities products? Are there other means to ensure transparency?

As a general rule, transparency is a public good. The financial crisis has shown the value in having transparent markets, as well as the need for regulators to have a detailed understanding of what activity is taking place in the markets.

As the Staff Working Paper notes, on a public trading venue, where standardised products are traded, information on prices is fully transparent to both public and regulators.

The question is therefore whether there should be more transparency of OTC trading activity in non-equity markets. The Commission should consider the optimum level of transparency considering the **liquidity and size of the market** and the nature of the relevant products. It will obviously be necessary to consider the needs of all market participants – for example to protect those committing capital to trading in illiquid

markets. We believe this can be achieved whilst still facilitating greater public transparency.

Q22: How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?

Enhanced transparency requirements (see Q21) and initiatives such as a central data repository may provide sufficient information to the market and public authorities. The additional benefit of transaction reporting may, as a consequence, be limited.

Q23: How should position reporting of derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on the exposures to particular contracts?

We believe that transaction reporting is a valuable tool of ensuring market integrity and preventing market abuse in EU markets.

Public trading venues

Q24: How can further trade flow be channelled through transparent and efficient trading venues? What would be the appropriate level of transparency (price, transaction, position) for the different derivatives markets?

As outlined above, **trading on an exchange brings important benefits**. We therefore encourage the Commission's objective to channel further trade flow through transparent and efficient trading venues: regulation has an important role to play in enabling markets to deliver increasing solutions for the exchange trading of derivatives.

We also recognise, however, that not all products are suitable for exchange trading and that there will continue to be a need for an OTC derivatives market, albeit subject to appropriate levels of transparency and controls. In particular, highly complex contracts that cannot be standardised should, for the reasons stated above, continue to be traded OTC.