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Competition Concerns about Clearing and Settlement in the Derivatives Markets [and Reasons why the Office of Fair Trading should Act]

The European Securities Services Forum (ESSF)¹ is pleased to respond to the invitation by the Office of Fair Trading (OFT) to provide comments on the competition issues raised by clearing and settlement in the derivatives markets.

In its 13 May 2008 Statement regarding the FSA granting recognition to ICE Clear Europe as a Recognised Clearing House for the purposes of the Financial Services and Markets Act 2000, the OFT referred to its preceding Report to the FSA, Competition Commission and HM Treasury on whether recognition would adversely effect competition. Although the Report concluded that the recognition of ICE Clear would not lead to a significantly adverse effect on competition, the OFT acknowledged that competition concerns had been expressed about clearing and settlement in derivatives markets and invited interested parties to comment thereon to the OFT.

The recent moves by derivatives exchanges (including the ICE and LIFFE) to establish their own clearing function raises a number of significant competition concerns. Our members believe that these moves will serve to:

Limit competition at the derivatives clearing level: The creation by derivatives exchanges of their own clearinghouses and the de facto requirement that exchange participants use that clearing function will impede competition and efficiency at the clearing level. Exchange control over where contracts are open and closed leaves users with no real choice of clearing venue, leading to monopoly pricing and dis-incentivising innovation. We are thus unconvinced by the futures exchanges' argument that the vertical integration of trading and clearing is an integral part of a business model that offers efficiency in post-trade services. As users we are not prepared to relinquish our support for open competitive clearing.

Limit competition at the derivatives trading level: Constraints on competition at the clearing level will also foreclose competition in the trading of derivatives since the protection offered by an incumbent exchange's clearing function will make it uneconomic for users to change trading venues. Witness for example the failed attempts by European derivatives exchanges (including Eurex and Euronext-Liffe) to attract business in some of the largest futures contracts away from Chicago's exchanges.

¹ The ESSF represents the interests of wholesale users of post-trade securities services acting as an agent of change providing solutions in the clearing, settlement and custody space to reduce costs and risks of market participants. It represents the views and positions of its members towards public sector authorities and central banks both at European and at national levels. The ESSF is an affiliate of the Securities Industry and Financial Markets Association (SIFMA) which brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA represents its members locally and globally.

Impact competition in cash markets: Any reduction in competition in trading and clearing of derivatives will spread to cash markets. The competitive pressures that have led derivatives exchanges to set up their own clearers are equally evident in the cash markets. For example, the LSE has seen its market share in UK equities eroded by Chi-X and is facing intense pressure from other coming platforms including BATS and Project Turquoise. In this context and with explicit reference to the vertical integration of derivatives exchanges, the LSE is currently conducting a strategic review of its post-trading arrangements which may lead it to drop LCH as its clearer and develop its own in-house post-trade services. Our members would be firmly against any such action.

The creation of exclusive vertical trading and clearing structures is completely at odds with the EU Code of Conduct on Clearing and Settlement which on a voluntary basis seeks open and competitive clearing in cash equities across Europe through interoperability between clearers. The EU Commission is actively considering the extension of the Code to other instruments including bonds and derivatives. This development and the impact of vertical derivatives structures on the post-trading strategy of equity exchanges is likely to increase the propensity of EU legislators to regulate clearing and settlement to halt the consolidation of vertical silos in Europe. Not only would such a move be fraught with risk of inappropriate regulation, it would certainly come too late to prevent the crystallisation of anti-competitive structures across Europe.

We urge the OFT to consider the above concerns in greater depth and stand ready to provide further evidence in support of our position. Should the OFT agree, we believe it is best placed to curtail exchange control of clearing and thus ensure competition in the trading and clearing of derivative and cash products, and render legislative intervention unnecessary.

Yours faithfully,



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