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Dear Becky

FCA Wholesale Sector Competition Review – FIA Europe response

We attach our response to the FCA Wholesale Sector Competition Review. In summary:

- The exchange traded and cleared derivatives markets are some of the most competitive markets in the global financial services industry;
- The FCA acting unilaterally in the UK: risks causing a fragmentation of liquidity and significant market disruption; could actively harm competition and choice; and could result in an uneven playing field across Europe, as well as against the US and Asia;
- Any gaps in existing regulation should be built on through a pan-European approach led by the European Commission, if not via the G20;
- We have seen certain venues impose market data fee charges at a level that reflects that they are the sole source of such data, further pushing up costs for users;
- MiFIR's non-discriminatory access provisions already address question 2;
- Investment firms providing a combined execution and clearing service have no material competitive advantage over those providing only a single service. The detrimental effect of the Basel III requirements on access to clearing via clearing brokers cannot be overstated;
- The volume of, and cost / operational risk involved in complying with, recent EU and domestic regulation is *itself* rapidly becoming one of the biggest barriers to entry – Basel III will inevitably have consequences on the competitive environment, as providers consider the viability of their commercial models;
- Competition issues associated with co-location are already proposed to be addressed via MiFID II;
- With respect to indirect clearing under EMIR and MiFIR, whilst we are working through some further proposals with our members and regulators, all previous models that have been discussed have been determined to not be economically viable or legally supportable - many of the smaller end users therefore risk becoming locked out of clearing OTC and exchange traded derivatives; and
- We see no reason to revisit competition issues previously considered.

We thank the FCA for their pro-active engagement with our Chairman and executive during this important consultation, and welcome any opportunity to discuss these concerns further with the FCA and their UK/European counterparts.

With kind regards,

Simon Puleston Jones
(CEO, FIA Europe)

In preparing this response, we have discussed the FCA's review with FIA Europe's board of directors, external counsel and FCA staff, including members of the team headed by your colleague Robin Finer.

On 16 September 2014, my colleagues and I attended the Trade Association Co-ordination Committee (TACC) meeting held at your office. As part of that meeting, Robin kindly walked the various trade associations in attendance through the background to this consultation and its aims. Essentially, having engaged in early market studies in the retail space, we understand that the FCA is now looking to engage with wholesale markets participants to ascertain which areas of those wholesale markets could potentially benefit from a closer review from a competition perspective.

The core of the review

Robin asked the attendees of that meeting the following questions:

1. Where can the FCA have the greatest impact?
2. Will the FCA acting unilaterally have no impact/be damaging?
3. Will new regulation that is already in train address the issues raised in the call for input, such that no further action is necessary?
4. Are there gaps in existing regulation that should be built on?

Whilst appreciating that the FCA has set out various questions in Annex 1 to the call for input published on 9 July 2014, we consider that the above questions are the "questions behind the questions" in Annex 1, i.e. regardless of what the answers are to the specific questions 1-7 (relating to markets and market infrastructure) in Annex 1, the above questions are ultimately the ones on which the FCA and industry alike should all focus – we nonetheless also respond to a number of the specific questions raised by the FCA in the call for input, under heading 3 below.

Whist the FCA is absolutely right to seek to identify areas of financial markets that are insufficiently competitive, careful thought must be given to the potential impact (including unintended consequences) of unilateral action taken by UK regulators.

Taking each of the above core questions in turn:

1. **Where can the FCA have the greatest impact?**

Given the enormous energy that has been, and continues to be, expended by the G20, FSB, European Commission, CPSS-IOSCO, the European Commission/Council of Ministers/Parliament, ESMA and the derivatives industry, among others, on reforming markets and market infrastructure since 2009 via the European Market Infrastructure Regulation, MiFID II/R and other regulation having its source in the G20 commitments of Pittsburgh 2009, **we do not consider that the areas identified in questions 2 to 7 of Annex 1 (*markets and market infrastructure*) are where the FCA, acting alone, can have the greatest impact**.

Whilst it is true that the mandatory clearing obligation under EMIR is not anticipated to start to come into effect until next year (over a 3 year phase in period) and MiFID II/R does not come into effect until 3 January 2017, the provisions of those regulations are well known by industry and regulators alike and all are busy building towards the new market infrastructure requirements set out therein.

In order to ensure that the new market infrastructure delivers efficient, transparent, pricing; maximises the opportunity to create safe, liquid markets; and ensures that users of that market infrastructure have sufficient choice when seeking to trade and/or clear in those markets, we fully agree with the FCA that it is important that sufficient competition exists in those markets.

We already consider that the exchange traded and cleared derivatives markets are extremely competitive and that the FCA can therefore have much greater impact in other parts of the financial services industry**:**

- Some exchange/CCP groups are already operating clearing arrangements with clearing houses that sit outside of their group (outside of their "silo"), several years ahead of being mandated to facilitate this pursuant to the non-discriminatory access provisions of MiFIR that come into force (subject to certain regulator-controlled exemptions) in 2017;
- There are already multiple clearing houses in the UK and continental Europe that have received authorisation under EMIR to clear the same type of derivative;
- A large number of clearing members provide clearing services for derivatives with respect to:
    - LMEClear (commodities – various metals, cobalt)
    - LCH.Clearnet Limited (listed and OTC commodities, OTC freight, interest rate swaps, foreign exchange, listed derivatives)
    - ICE Clear Europe (interest rate, equity index, agricultural and energy derivatives; and credit default swaps)
    - CME Clearing Europe (interest rate, agricultural, energy, freight and precious metal derivatives; and interest rate swaps);
- Notwithstanding that the majority of volume of derivatives cleared through such clearing houses is concentrated amongst a comparatively smaller number of investment firms, the competition is extremely intense. Their clients have extremely high expectations regarding quality and price of execution and clearing, asset protection and additional optional services provided by many brokers such as margin financing and margin transformation;
- Within the exchange traded derivatives markets, clients are able to readily vote with their feet if they are not happy with the service that they are receiving from their current execution and/or clearing broker. These markets are extremely liquid and there are numerous alternative providers. On the execution side, an end user participant can simply switch execution broker. if it doesn't like the service it is receiving. On the clearing side, "pre-default porting" (i.e. the process by which a client novates its positions and collateral to an alternative clearing member, in the absence of default of any party) is a long-established, business as usual, process that can often be accomplished within a day or two;
- We note that incoming regulation applicable to asset managers is also expected to increase the number of requests for particulars (RFPs) received by clearing brokers, further increasing competition for such asset manager's business; and
- End users have established back up clearing relationships with clearing brokers, which allows them to readily and quickly move business in times of stress or when alternative providers offer more attractive commercial terms.

Market Data Fees

The one area where we do have a degree of concern is access to market data. This has been an area of increasing regulator focus – we consider that focus timely, given that we have seen certain venues impose market data fee charges at a level that reflects that they are the sole source of such data, further pushing up costs for users.

2. Will the FCA acting unilaterally have no impact/be damaging?

In short, we believe that such unilateral action would be extremely damaging.

The derivatives markets are global. Any action by an individual country that is out of step with actions taken in a coordinated, controlled, fashion by fellow regulators in other major relevant EU and non-EU markets risks causing a **fragmentation of liquidity (so hampering the ability of end users to risk manage their exposures as part of their legitimate hedging strategies) and significant market disruption (as users and service providers move their business outside of the UK).**

Further, the FCA acting unilaterally could actively harm competition and choice in UK markets and result in an uneven playing field across Europe, in direct contravention of the intention expressed through the G20 commitments of Pittsburgh 2009.

3. **Will new regulation that is already in train address the issues raised in the call for input, such that no further action is necessary?**

The answer to this question in most areas with respect to markets and market infrastructure is "yes":

- With respect to **question 2** (*competition between market infrastructures*), any concerns regarding the lack of ability of a market infrastructure to connect with a trading venue or clearing house that falls outside of its group (outside of its "silo") **is more than adequately addressed through the non-discriminatory access provisions of MiFIR**.

  With respect to **questions 3 and 4** (*competition between standalone execution brokers/clearing brokers vs. those that provide a combined execution and clearing service*), the general presumption in the question that those providing a combined execution and clearing service have a competitive advantage does not hold **– those providing combined services have no material competitive advantage to those merely providing a single service – in fact, to the contrary, providing clearing is extremely costly, but clients expect it.** It is extremely expensive to provide a clearing service due to the impact of the regulatory capital requirements under Basel III – billions of Euro of regulatory capital has to be held on the balance of the largest clearing brokers to support the provision of clearing services. RBS offered such a combined service, and yet it found it extremely challenging to grow its business in this competitive, very highly regulated, thin profit margin, business line, which led to it choosing to wind down significant parts of its OTC client clearing swaps business earlier this year. **The detrimental effect of the Basel III requirements on access to clearing via clearing brokers cannot be overstated.**

- With respect to **question 5** (*competition issues relating to concentration*), we note that **the volume of, and cost / operational risk involved in complying with, recent EU and domestic regulation is *itself* rapidly becoming one of the biggest barriers to entry** and a reason often cited by those service providers who have recently left the cleared derivatives industry.[1] Whilst on the execution side, it remains comparatively cheap to set up an execution broker service, if you wish to provide an OTC client clearing service, the costs of complying with all applicable regulation (especially regulatory capital requirements applicable to investment firms) is prohibitive and acts as a major barrier to entry.

[1] By way of illustration, we note that:

- BNY Mellon announced last week that it is closing its derivatives clearing unit in Europe, having already closed its US clearing unit, due to the regulatory capital costs involved of providing a clearing service and the delay in the start of the mandatory clearing obligation under EMIR (see www.FOW.com, "BNY Mellon shuts European clearing unit" by Luke Jeffs, 30 September 2014); and
- RBS wound down its swaps clearing unit earlier this year (see www.ft.com "RBS to wind down part of swaps clearing unit" by Philip Stafford, 18 May 2014)

The cost of setting up a new clearing house is also prohibitive, albeit the recent successful launch of LME Clear demonstrates that those silos with the very deepest pockets still have the financial resources to do so[2]. Given the significant fee increases that coincided with the launch of that clearing house, it is clear that end users are the ones who ultimately suffer from the extremely high costs of regulatory implementation, by way of having to pay (directly or indirectly) higher execution and clearing fees.

- With respect to **question 6** (*competition issues associated with co-location*), these issues are already proposed to be addressed via MiFID II. MiFID II provides that trading venues should ensure that their rules on co-location services are transparent, fair and non-discriminatory. One of the points that ESMA picks up on in its discussion paper is that when deciding whether co-location services are transparent and fair, the pricing of such services must also be considered, primarily whether the pricing models used by the providers are applied in a transparent, fair and non-discriminatory manner to all users of the service.[3]

- Another area of significant concern is indirect clearing under EMIR (for cleared swaps) and MiFIR (for exchange traded derivatives). With respect to indirect clearing under EMIR and MiFIR, whilst we are working through some further proposals with our members and regulators, all previous models that have been discussed have been determined to not be economically viable or legally supportable - many of the smaller end users therefore risk becoming locked out of clearing OTC and exchange traded derivatives.

4. **Are there gaps in existing regulation that should be built on?**

For the same reasons set out above, **any gaps in existing regulation should be built on through a pan-European approach led by the European Commission**, acting together with its partners at ESMA and the various national competent authorities within the EU, **if not via the G20**, to develop a framework that works on a cross-border basis, reflecting that these markets are typical global, not domestic.

[2] We note that, even with such resources, the London Metal Exchange still increased their combined execution and clearing fees by 34% within a week of launching the new clearing house “LME Clear” on 22 September 2014, in order to go part of the way to meeting such costs (see www.ft.com, “LME plans to raise fees by a third” by Josh Noble, 29 September 2014). In the period prior to the transfer of the clearing of LME products from LCH.Clearnet Ltd to LME Clear on 22 September 2014, clearing fees increased 300%.

[3] See: http://www.nortonrosefulbright.com/knowledge/publications/118315/mifid-ii-mifir-what-it-means-for-market-infrastructure