

13 May 2003

James Sassoon Esq
HM Treasury
1 Horse Guards Road
London
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Dear James

THE FINANCIAL SYSTEM AND MAJOR OPERATIONAL DISRUPTION

The purpose of this letter is to provide Euronext.liffe's main comments on the Treasury's consultation paper concerning major operational disruption to the financial system. Our detailed comments on the paper will be sent to the Treasury's consultation team shortly.

Our main points can be summarised as follows:

- We believe that there is a case for the authorities to have powers that could be used, if necessary, as a means of supporting or helping to facilitate the financial services community's response to major disruptive events. For example, as the Treasury consultation paper points out, such powers may provide legal protection in relation to the opening or closure of exchanges and clearing houses during such an event.
- Notwithstanding this, in order to allay fears that the powers might be used inappropriately – for political or other invalid purposes - it is vital that such powers, and the way in which they are to be applied, are appropriately targeted and defined. Otherwise, the existence of the powers is likely to undermine certainty about the availability and operation of London's markets, and hence customers' confidence in those markets.
- Given the very limited time that the Treasury has had to formulate the current proposals, it is understandable that, at present, they lack substance and are not adequately defined. This creates uncertainty about the way in which they would be applied to each market. In particular, it is unclear how the proposed powers would work in relation to existing arrangements for tackling major operational disruption.
- As a result, we believe that the next step should be for the Treasury to undertake more detailed and systematic analytical work, with input from the private sector, to codify existing arrangements for tackling major operational disruption and identify any gaps or other issues that suggest that action by the authorities is warranted, so that an informed and properly considered consensus can be reached on the nature and application of any new powers, and whether they should be exercisable by the Treasury, the Bank of England or the FSA.

- We therefore agree with the London Investment Banking Association, and other trade associations, that in the near term the Treasury should work with the financial services industry to conduct the necessary detailed analysis, rather than rushing into legislation. We appreciate that this would mean that the imminent Civil Contingencies Bill could not be used as the legislative vehicle for any new powers. However, for the reasons explained above we believe that it is more important for the legislation to be appropriately targeted and defined than for it to be enacted as speedily as is currently planned. Legislating before the necessary detailed work is done would, in our view, be unsatisfactory.

These comments are explained at greater length in the enclosed note.

Euronext.liffe is willing to assist the Treasury in conducting the necessary analysis referred to above and to work with the authorities and the industry to build an informed consensus on the nature and application of any new powers. Laurence Walton at Euronext.liffe (telephone number 7379 2782) would be pleased to co-ordinate the necessary input in relation to the LIFFE market.

Yours sincerely

Hugh Freedberg
Chief Executive

THE FINANCIAL SYSTEM AND MAJOR OPERATIONAL DISRUPTION

1. Introduction

- 1.1 The purpose of this note is to provide Euronext.liffe's main comments on the Treasury's consultation paper concerning major operational disruption to the financial system which, in particular, seeks views on proposed statutory powers that would enable the Treasury to suspend contractual obligations and give directions to "infrastructure providers", including exchanges.
- 1.2 Euronext.liffe, the derivatives business of Euronext and LIFFE, understands the Treasury's desire to act as a facilitator at times of major operational disruption. The question is how this is best achieved, given:
- (i) the current arrangements that exist for tackling major operational disruption; and
 - (ii) the characteristics of the London markets.

2. Consistency with Current Arrangements

- 2.1 Any new powers would need to be consistent with and complement the existing powers and mechanisms for dealing with major operational disruption. These include the authorities' formal and informal means of intervening at times of crisis¹ as well as long-established arrangements that have been put into place by private sector bodies.
- 2.2 As an example of the latter, LIFFE has a robust and comprehensive set of arrangements – including detailed business continuity plans and emergency powers/force majeure provisions in its Rules and the Contract Terms of exchange contracts – to deal with major operational disruption. These private sector arrangements are crucial because, as the consultation paper makes clear, the main responsibility for responding to the effects of major operational disruption can only realistically rest with those within the private sector who have the necessary experience and expertise of operating the market concerned.
- 2.3 Whilst we welcome the fact that the Treasury consultation paper recognises that the private sector must continue to play the leading role – and that, to the extent feasible, it is intended that the Treasury powers would only be used with the support of the private sector - in our view the paper does not take adequate account of the need for consistency with existing arrangements to deal with major operational disruption or the characteristics of the London markets. This is because the paper is written at a high level of generality, which creates uncertainty about the way in which the powers would be applied to particular markets. Certainty is, of course, important for market participants, giving them confidence in the availability and operation of markets. The Treasury must be extremely careful not to dilute that certainty and confidence. There is a significant risk

¹ Including the Treasury's powers to prohibit certain transactions under the Banking and Financial Dealings Act 1971 and the FSA's powers of direction under the Financial Services and Markets Act 2000.

of such dilution because the proposed additional powers for dealing with major operational disruption are currently broadly-based and their application is undefined.

2.4 Although the paper is a very useful first step in initiating the debate about the need for additional Treasury powers, its general and somewhat nebulous nature makes it extremely difficult to draw the conclusion that the powers, as proposed, would be beneficial to London's markets and their customers. As a result, we believe that the next step should be for the Treasury to undertake more detailed and systematic analytical work, with input from the private sector, to codify existing arrangements and identify any gaps or other issues that suggest that action by the authorities is warranted, so that an informed and properly considered consensus can be reached on the nature and application of any new powers. This would include considering whether, as proposed, any new powers should be exercisable by the Treasury or whether it would be more appropriate to confer those powers on the Bank of England or the FSA.

2.5 We therefore agree with the London Investment Banking Association, and other trade associations, that in the near term the Treasury should work with the financial services industry to conduct the necessary detailed analysis, rather than rushing into legislation. Whilst this would mean that the imminent Civil Contingencies Bill could not be used as the legislative vehicle for any new powers, we believe that it is more important for the legislation to be workable and effective than for it to be enacted as speedily as is currently planned.

3. Characteristics of the London Markets

3.1 Any new powers would not only need to be consistent with existing powers and mechanisms for dealing with major operational disruption, they would also need to take full account of the key characteristics of the London markets.

3.2 As the Treasury is aware, the markets in London are characterised by:

- (i) their diverse and uniquely international nature, in terms of both customer base and products traded;
- (ii) the complex relationship between exchange-traded and OTC markets, which is partly complementary and partly competitive; and
- (iii) for derivatives markets in particular, the strong demand from market participants for markets to remain open in times of emergency, wherever possible, since it is precisely in such circumstances that market participants most need to be able to manage their exposure to risk. In addition, market participants demand certainty about the availability and operation of infrastructure providers, whereas additional powers that are broadly-based, and whose application is undefined, may serve to undermine that certainty and hence market participants' confidence in the markets. For these reasons, LIFFE remained open in the immediate

aftermath of the 1987 hurricane which, as chance would have it, coincided with a stock market crash; and following the tragic events of 11 September 2001².

- 3.3 These characteristics of the London markets – each of which is a significant competitive strength for London as a financial centre – create difficult issues for policy makers attempting to augment the current arrangements that exist for dealing with major operational disruption.
- 3.4 For instance, the uniquely international nature of London’s markets differentiates them from the markets in most other major financial centres, such as New York. London’s markets mainly serve international market participants and customers trading international products. These users have no inherent “loyalty” to London, and will only continue to do their international business here if it remains the best place in which to conduct such business. In contrast, New York’s markets focus mainly on serving domestic market participants and customers trading predominantly in domestic products. Moreover, in relation to U.S. securities markets in particular, protectionist barriers to a large extent insulate New York’s markets from competition from markets located outside the United States.
- 3.5 These considerations have two important consequences. First, they mean that it is more feasible for the U.S. authorities to halt trading activity than it would be for the UK authorities. The international nature of business done in London – along with fierce competition from overseas exchanges, and the existence of highly developed OTC markets, both here and abroad – is likely to undermine the Treasury’s aim to use the proposed powers in order to create a “breathing space” during which firms and infrastructure providers can focus solely on tackling the effects of major operational disruption. In practice, firms will have outstanding exposures that they will need to manage and any Treasury direction to UK exchanges to halt trading activity may serve only to displace such activity (potentially to a less transparent venue), rather than halt it.
- 3.6 Secondly, as trading activity in New York is far less mobile than is the case in London, the UK authorities need to be far more mindful than the US authorities of the potential for the uncertainty created by any broad-based powers undermining the attractiveness of the financial centre as a place in which users have continued confidence.
- 3.7 As an example of the international nature of London’s markets, Euronext.liffe’s electronic trading system, LIFFE CONNECT™, is readily accessible from over 600 dealing rooms worldwide, two thirds of which are located outside the UK. The derivatives products traded on the LIFFE market are not based only on domestic UK underlying products. Instead, the vast majority of business transacted on the LIFFE market is based on underlying international money market deposits, bonds, swaps, equities, equity indices and commodities. It is therefore vital to Euronext.liffe that the approach and/or response of the Treasury reflects London’s uniquely international reach.

² Albeit that in the case of 11 September 2001, for understandable reasons LIFFE temporarily suspended trading of a small number of futures contracts that are based on U.S. stocks.

3.8 The diverse nature of London markets means that it is not possible to adopt a “one size fits all” approach to halting trading activity or suspending contractual obligations. This diversity exists in the following areas:

- **Product types:** some products, such as options, have “time value” whereas others, such as cash securities, do not. They will, therefore, be affected differently by, for instance, any uniform direction that does not cater for their specific characteristics.
- **Concentration:** whilst most London exchanges, including LIFFE, have migrated to screen trading, some continue to rely, to a greater or lesser extent, on physical trading floors. In the case of the former, traders will be located in separate premises – not just within London, but across different jurisdictions and, indeed, continents – whilst in the case of the latter, traders will necessarily be concentrated in a single location in London. OTC markets too are, by their very nature, decentralised. The impact of a major disruptive event in London may therefore differ significantly from market to market.
- **Technical infrastructure:** screen based exchanges may locate their trade matching engines and associated systems within or outside London. Moreover, they may operate from a prime site, backed-up by a contingency facility or they may have dual site operability whereby each site is in “live” mode on an ongoing basis (LIFFE works on the basis of dual site operability). Again, given the diversity of technical arrangements, a major disruptive event in London will affect London’s exchanges differently.

3.9 Two further aspects would need to be taken into account in relation to LIFFE. First, LIFFE is the technology provider not only for the LIFFE market but also for other markets within Euronext.liffe (Euronext.liffe comprises regulated markets established under the laws and regulatory systems of five European jurisdictions³). Therefore, any direction given to LIFFE could have unintended consequences for those other markets and their regulators. Secondly, as explained above, LIFFE’s technical infrastructure works on the basis of dual site operability and we plan to re-locate one of the live sites to France later this year. Depending on the circumstances, it may therefore be possible to continue technical operation of the LIFFE market, notwithstanding a major disruptive event which might have affected London.

3.10 As explained in this section of the note, halting activity or suspending obligations will affect different markets in different ways and any new powers would need to cater for the diversity of London’s markets. Moreover, as explained above, any intervention would need to take account of the strong demand from market participants for London’s markets to remain open in times of emergency, wherever possible. It would also need to reflect the uniquely international nature of London’s markets. This means, for instance, that it is far less straightforward for the UK authorities than, say, the US authorities, to develop powers which are both effective and which would not undermine the attractiveness of the financial centre as a place in which users have continued confidence.

³ Belgium, France, The Netherlands, Portugal and the UK.

4. Conclusion

- 4.1 We believe that the next step should be for the Treasury to undertake more detailed and systematic analytical work, with input from the private sector, to codify existing arrangements for tackling major operational disruption and identify any gaps or other issues that suggest that action by the authorities is warranted, so that an informed and properly considered consensus can be reached on the nature and application of any new powers. This would include considering whether, as proposed, any new powers should be exercisable by the Treasury or whether it would be more appropriate to confer those powers on the Bank of England or the FSA.
- 4.2 Euronext.liffe is willing to assist the Treasury in conducting the necessary analysis referred to above and to work with the authorities and the industry to build an informed consensus on the nature and application of any new powers.