

02 May 2003



Dan Lambeth
The Financial System and Major Operational Disruption
FSM team
Room 4/16
HM Treasury
1 Horse Guards Road
LONDON
SW12 2HQ

Dear Dan,

Response to the consultation on ‘The financial system and major operational disruption.’

Please find herewith the response of the International Petroleum Exchange (‘IPE’) to HM Treasury’s Consultation Paper on ‘The financial system and major operational disruption’ (Cm 5751).

About the International Petroleum Exchange

The IPE is Europe’s leading energy futures and options exchange. It was established in 1980 and offers five main energy contracts: Brent Crude futures and options, Gas Oil futures and options, and Natural Gas futures. In February 2000, the IPE’s Members voted to demutualise the Exchange in order to separate trading rights from ownership. The IPE became a wholly-owned subsidiary of IntercontinentalExchange Inc. on 10 August 2001. The IPE is regulated by the Financial Services Authority (FSA) as a recognised investment exchange (‘RIE’) under Part XVIII of the Financial Services and Markets Act 2000 and also has regulatory approval to place trading screens in a number of EEA jurisdictions, Switzerland and the United States.

General comments

The IPE broadly supports the intentions of the paper and agrees that it is crucial to have a coordinated response to a major operational disruption such as the tragic events of 11th September 2001. The existence of one central authority at such a time of crisis would help to ensure an effective, efficient and co-ordinated response involving various government agencies, regulators, market authorities, clearing houses and market participants. However, we believe that there are a number of practical issues which undermine both HM Treasury’s intention and the proposed legislation solutions as set out in the Consultation Paper. The key areas of concern are the:

- (i) definition of a major operational disruption;

- (ii) scope of the proposals (both in terms of products and trading venues);
- (iii) need for timely action in the event of a major operational disruption;
- (iv) international nature of UK markets (especially, from a parochial point of view, the commodity derivatives markets);
- (v) practical consequences of the exercise of the power to suspend financial obligations;
- (vi) lack of sufficient analysis of current legislation and market practice;
- (vii) panoply of existing legal and regulatory requirements imposed on the UK's recognised bodies;
- (viii) impact of the power of direction; and
- (ix) appropriate body to coordinate the industry response.

These issues are discussed further below, along with a discussion of the IPE's existing legal obligations and arrangements for dealing with a major operational disruption. It is vitally important that there is full and proper reflection on these issues which, in our view, preclude the need for any legislation as part of a Civil Contingencies bill at this juncture.

(i) Definition of a major operational disruption

One of the IPE's key concerns relates to the definition of a "major operational disruption." The proposals seem to envisage a 'September 11th' scenario but could also cover severe weather situations. In the absence of further definition we are concerned that draconian powers could be introduced to tackle such events but then used in an inappropriate manner. The trigger for the use of such emergency powers must be a catastrophic incident that makes it impossible for a large number of market participants and market infrastructure providers to function. While it is difficult to imagine such an incident, it is important that if HM Treasury were given such powers they are only used to counteract such a nihilistic event and such clarity must be added to any legislation. As described on page 29 of the Consultation Paper, it is also imperative that such powers would "only be usable in a case of major operational disruption, and never in a purely financial crisis."

(ii) Scope

By their very nature, any powers under a proposed Civil Contingencies Bill would be limited by the extra-territorial application of UK law or possibly any contracts governed by UK law. It is crucial that any suspension or direction power extends not only to those products traded on the UK's recognised investment exchanges, but also to any trading in look-alike or OTC products which could be used for the same purpose and the Alternative Trading Systems (ATSS)/platforms where these trade. For example, in the securities markets – it is illogical to order a suspension of the London Stock Exchange without also preventing trading in those equities on Virt-X, Instinet and other ATSS. This definition should therefore be very broadly drawn (in order to capture the full range of products, in our view, this should be drawn more widely than the definitions used under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001). It is also important that the legislation covers the operational elements of the market infrastructure, such as telecommunications providers which play a vital role in the operation of the UK financial system.

(iii) Speed of response

Any decision to close or suspend a market will need to be taken within a short timeframe – generally within the so-called 'golden hour' following an event. It is very difficult to imagine any instance whereby the Exchange would wait until it was directed to do so before ordering a suspension of the market where it considered that this was in the best interests of the market. In the

event that there was a disruption to the communication infrastructure this would only serve to exacerbate the delay. Further, the Exchange could be in breach of its statutory duties – such as the requirement to operate an orderly and proper market - if it did not implement a halt on trading immediately. This, of course, contradicts the key theme of the Consultation Paper which is the need for a consolidated response. However, it is imperative that market infrastructure providers have clear authority to make the decision in the best interests of the market without waiting for a direction from a ‘higher’ authority.

(iv) Global nature of the commodities markets

Clearly, the international dimension and impact of any powers implemented in the UK must be properly assessed. The consequences of the global aspect are particularly acute in the commodities markets. These markets are by their very nature global - the IPE plays a key role in world commodity markets and the IPE Brent crude futures contract acts as a benchmark for two thirds of the world’s internationally traded crude oil and production from the Middle East, South America, Europe and the Far East prices directly or indirectly against Brent therefore allowing users to manage risk effectively through the IPE Brent crude futures contract. The IPE’s key competitor in the world markets is the New York Mercantile Exchange (NYMEX) and it is important to appreciate that the impact of any suspension or direction raises both competitive and operational risks.

Commodity derivatives markets perform two key functions within the commodities markets: firstly derivatives on commodities allow producers and consumers to buy/sell futures contracts that fix the price of future purchases or sales and thereby reduce the risk of price volatility and uncertainty prior to delivery; and secondly, these markets allow price formation as market participants bring to the marketplace their knowledge of current supply and demand conditions and their future expectations. Prices change frequently as the participants revise or re-evaluate their views on the basis of new information, and buy and sell futures contracts in accordance with those expectations. Irrespective of the operational disruption in London, market participants will still need to hedge their underlying exposures and therefore it is likely that they will look for an alternative mechanism in order to hedge their risk – this could conceivably lead to a loss of business to overseas competitors.

Echoing the comments in the response to this Consultation Paper by the Federation of European Securities Exchanges in their response, we would strongly encourage HM Treasury to explore the possibility of using this work as a spring-board for European and global action in this area. Given that the IPE’s main competitor is US-based, the opportunity to explore unilateral response to the issue of handling major operational disruption should be considered further.

In terms of operational risks, any exercise of powers should also take into account the large amount of OTC and off-exchange trading which use the IPE’s settlement prices as reference prices. Clearly, any suspension of trading or financial obligations will have an impact on the calculation of settlement prices and should therefore be one of the factors taken into consideration before the exercise of any power. Please note that the IPE Regulations provide that in the event of an emergency closure, the IPE can convene a Settlement Advisory Committee to calculate the settlement price.

(v) Impact of a suspension of financial obligations

The exercise of a power to suspend financial obligations brings with it a number of practical difficulties. While these issues would be most acute for the clearing and settlement infrastructure - most notably the IPE’s purposes the London Clearing House which acts as a central counterparty

for all contracts traded on the IPE - the ramifications could include the loss of confidence in the IPE's markets as well as causing the IPE to breach its regulatory obligations relating to the timely discharge of rights and liabilities of parties transacting on the Exchange. Further a raft of practical consequences could arise from the power to suspend the financial obligations including, *inter alia*, triggering cross default clauses, impacting margin calls and wider complications where the obligations are part of a complex web of interlocking contracts.

(vi) Legal issues

It is important that there is a full and proper analysis of the both the legal issues which the proposed legislation seeks to address and also the implications of the introduction of such legislation. This analysis must be conducted from a City-wide perspective, and also include any international dimensions. It is suggested that the Financial Markets Law Committee is the appropriate body to conduct such an analysis which should cover, *inter alia*, the powers currently available to public authorities, a comparison of the powers available in other jurisdictions, the interdependencies between the UK and other marketplaces, contract terms which could be affected in the event of any major operational disruption – such as *force majeure* clauses and business days.

(vii) Prevailing obligations on the IPE and current arrangements for handling an operational disruption

In order to assess the need for a power of direction to be framed within a Civil Contingencies Bill, it is important to consider the panoply of existing obligations on the UK's recognised bodies and the voluntary arrangements currently in place to respond to a major operational disruption.

These obligations are briefly discussed in Chapter 7 of the Consultation Paper, but it is important to note the obligations which recognised bodies must comply with the various IOSCO publications in this area,¹ the 'Standards for Regulated Markets' issued by the Federation of European Securities Commissions (December 1999) and most pertinently UK law. In the UK, the prevailing requirements relating to business continuity are: (i) the requirement to ensure that "business conducted by means of its facilities is conducted in an orderly manner and so as to afford proper protection to investors" under the Financial Services and Markets Act 2000 (Recognition Requirements for investment exchanges and clearing houses) Regulations 2001; and (ii) in REC 2.5.19(6)G FSA's Sourcebook for recognised investment exchanges and recognised clearing houses relating to the "arrangements made to ensure business continuity in the event that an information technology system does fail".

The IPE has detailed business continuity plans in order to respond to an operational failure. The Exchange operates a 'warm' disaster recovery site in south-east London which will become operational within 24 hours of the invocation decision. The IPE is also in the process of moving towards fully electronic trading of its products onto the trading platform provided to the IPE under an arm's length agreement by the IntercontinentalExchange, Inc. ('ICE Platform'). The ICE Platform is accessed via a web-based internet connection which should allow Members to access the Exchange in a more flexible manner during times of operational disruption (on the basis that telecommunication lines allow such access). The Exchange has also introduced rules facilitating telephone trading in situations where the systems failure would prevent computer-based trading. It is also worth noting that the Directors of the Exchange have the power to declare any day a non-business day on giving notice thereof to Members (Rule A.5.1). The power to close the Market in compliance with a suspension under the Banking and Financial Dealings Act 1971 is included under

¹ Such as the Principles for the Oversight of Screen-based Trading Systems for Derivative Products (1990), Objectives and Principles of Securities Regulation (1990) and Report on Trading Halts and Market Closures (2002).

Rule A.8(b). The relevant section of the IPE Regulations relating to emergency closures (Rule G.14) is set out in Appendix 1.

The IPE is also active in a number of cross-industry bodies which are designed to co-ordinate the response to any major disruption of financial systems. Perhaps the most important of these is the Markets and Exchanges Regulatory Liaison Information Network (MERLIN) sub-group on contingencies where representatives of recognised bodies meet to discuss further co-operation on practical issues. The IPE is also a member of the Federation of European Securities Exchanges which has a similar sub-group and also the Joint Exchange Council. In our view these allow for sufficient consultation throughout UK's recognised bodies without the need to impose an additional level of bureaucracy.

(viii) Impact of the power of direction

It is vital that the use and impact of the power of direction is carefully assessed. Only those persons involved in the day-to-day management of market infrastructure providers properly understand what such systems are capable of in a crisis and it is therefore difficult to see how any third party could exercise better judgment than that of these managers. This will require considerable work in advance of the use of any power of direction with each recognised body or market infrastructure provider on both an individual and collective basis. Where a recognised body is directed to do an act, it is imperative that this would come with legal protection from liability. It is therefore important that the proposition made in paragraph 7.26 the "it might be appropriate for a direction order to protect the users from the legal consequences of this" is strengthened.

(ix) Appropriate coordinating body

It is unclear whether HM Treasury is the appropriate body for the coordination of a response to a major operational disruption. Understandably, following such an event, there will be intense political pressure to act. However, there are strong arguments that either the Bank of England or the FSA would be the most appropriate body to continue this oversight. For example, under section 296 of the Financial Services and Markets Act 2000, the FSA have the power to direct a recognised body to act so that it will continue to meet its Recognition Requirements and this would enable them to ensure an appropriate response to a major operational disruption. Meanwhile, the Bank of England has considerable experience in coordinating the response of the UK financial services sector as evidenced by its central role in the preparations for Year 2000 and the introduction of the euro although this may lead to confusion without a clear demarcation of responsibility.

Responses to specific questions

Please find attached in Appendix 2 our response to a number of specific questions.

Concluding comments

In the light of these general comments and the responses to specific questions which highlight the complexity of the unresolved practical issues, while supporting HM Treasury's original intentions, we do not believe that the case has been made for enacting legislation to help promote order in the financial system in the face of major operational disruption. In our view it would also be helpful to review the conclusions drawn by the various reports produced by, amongst others, the US Securities

and Exchanges Commission² and Commodities and Futures Trading Commission³ following the events of September 11th. What is notable about their conclusions is that they do not call for the implementation of further legislation.

However, HM Treasury's proposals have engendered lengthy and lively debate amongst market participants and city institutions and therefore this has undoubtedly been a fruitful exercise irrespective of the result. Pending legal analysis and the opportunity for a further market response this may lead to a clearer view of the powers which would facilitate a measured and appropriate response to a major operational disruption. In our view such analysis would help to prevent the introduction of defective and imperfect legislation.

Should you have any questions on the issues raised in this response, please do not hesitate to contact my colleague Mark Woodward on 020 7265 5729 or myself on 020 7265 3608.

Yours sincerely,

Marc Leppard
Director – Regulation and Compliance

² Such as the "Interagency Paper on Sound Practices to Strengthen the Resilience of the US Financial System" produced by the Federal Reserve System [Docket No. R-1128], Department of the Treasury Office of the Comptroller of the Currency [Docket No. 03-05] and Securities and Exchanges Commission [Release No. 34-47638] (April 7, 2003).

³ "Report of the Commodity Futures Trading Commission on the Futures Industry Response to September 11th" (March 11, 2002).

IPE Regulation G.14 relating to Emergency Closures

G.14 EMERGENCY CLOSURES⁴

- (a) Trading on the Market may be temporarily suspended by an Exchange official in the event of a fire alert, bomb scare or other alarm or in such other event which in the opinion of the Exchange official suspension of trading is necessary in the interests of the Exchange, or its Members, or to maintain a fair and orderly market. Trading will be resumed as soon as reasonably practicable following any such interruption.
- (b) In the case of trading on the trading floor:
 - (i) the Floor Committee, in consultation with an Exchange official, shall have the authority to order a 5 minute cessation of trading followed by the extraordinary opening procedure (EOP) if, in the opinion of those members of the Floor Committee present on the trading floor, trading has become or is likely to become too hectic or volatile for reasonable open trading conditions. The procedure involved in the EOP shall be the same as that of a standard opening procedure. There is no limit on the frequency of use of the EOP should the volatility continue or reoccur;
 - (ii) if the designated Exchange official considers that as a result of action under (a) or (b)(i) above trading on the trading floor either may not be resumed before the time for the commencement of the closing procedures for a contract, or may not be resumed at a time which, in his opinion, would leave sufficient time before the closing time of that contract as would allow the determination of a representative settlement price, such Exchange official shall either
 - (i) declare trading in that contract suspended for the day. The settlement prices for that contract shall be determined by the Senior Exchange Official who may consult the Settlement Advisory Committee and who may take into account any one or more of the points listed in Floor Trading Procedure 2.4.10; or
 - (ii) refer the matter to the designated Exchange senior management official who may declare that trading continues on the Telephone Trading market pursuant to Rule G.18; or
 - (iii) decide (after consultation with such persons as the Exchange in its sole discretion may decide) whether to bring forward the scheduled starting time for trading any affected Contracts on IPE ETS.
- (c) In the case of trading on the IPE ETS, two designated Exchange officials may declare that trading on the IPE ETS has been suspended and will remain so until all the consequences of such an event have been remedied to their satisfaction. If the two designated Exchange officials consider that as a result of action under (a) above trading in respect of those contracts other than Utility Contracts may not be resumed before the end of the trading session , such Exchange officials will either:
 - (i) declare the trading session suspended ; or
 - (ii) refer the matter to the designated Exchange senior management official who may declare that trading continues on the Telephone Trading market pursuant to Rule G.18.

If the two designated Exchange officials consider that as a result of action under (a) above, trading in respect of Utility Contracts may not be resumed at a time which, in their opinion, would leave sufficient time before the end of the trading session as would allow the determination of a representative settlement price, such Exchange officials will either:

- (i) declare the trading session suspended and determine the settlement prices; or
- (ii) refer the matter to the designated Exchange senior management official who may declare that trading continues on the Telephone Trading market pursuant to Rule G.18.

Responses to specific questions

Question 3c – Is there more that could usefully be done by the private sector to strengthen market co-operation? Is there a role for the authorities in assisting with this?

In general terms there both benefits – most notably the involvement of the key individuals who are responsible for dealing with market disruptions - and disadvantages – such as the informal nature of such groups and lack of clear leadership - to private sector co-ordination. The authorities can play a key role in assisting the informal mechanisms which are already in place – such as acting as a central authority in a time of crisis, ensuring impartial arbitration where differing opinions exists with market participants and preventing infrastructure providers taking action which may not be in the wider interests.

The IPE is also active in a number of cross-industry bodies which are designed to co-ordinate the response to any major disruption of financial systems. Perhaps the most important of these is the Markets and Exchanges Regulatory Liaison Information Network (MERLIN) sub-group on contingencies where representatives of recognised bodies meet to discuss further co-operation on practical issues. The IPE is also a member of the Federation of European Securities Exchanges which has a similar sub-group and also the Joint Exchange Council. In our view these bodies allow for sufficient consultation between the UK's recognised bodies with the input of HM Treasury, the FSA and the Bank of England and it is difficult to see how the authorities could strengthen this approach without imposing an additional level of bureaucracy.

Question 4a – In principle, would it be useful to have new legislation to help promote order in the financial system in the face of major operational disruption?

For the reasons given in the general comments the IPE does not believe that the case has been made for creating new legislation to help promote order in the financial system in the face of major operational disruption.

Questions 4c – If new legislation were to be sought, are the suspension and direction powers the right choices? Are there any other types of legislation that might be useful to help promote order in the financial system?

For the reasons given in the general comments (above) the IPE does not believe that the case has been made for creating new legislation to help promote order in the financial system in the face of major operational disruption. Further, it is worth noting that the conclusion of both the US SEC and CFTC reports into September 11th did not call for the enactment of any further legislation.

Question 5a – Have you any comments on the possible approaches to making secondary legislation/administrative directions, including who should exercise this function, the attractiveness of potential fallback routes for making the secondary legislation/administrative directions, accountability to Parliament and modification of secondary legislation/administrative directions?

For the reasons outlined above, it is our views that the appropriate authority to take decisions relating to the use of the power of direction or suspension, would either be the Financial Services

Authority (on the basis of their existing powers) or the Bank of England (by virtue of their experience in successfully co-ordinating the response of the UK financial services sector to Year 2000 and the introduction of the euro). It is, however, imperative that there is a clear demarcation of responsibility in order to prevent confusion in the event of a major operational disruption.

Question 5d/e – If the powers were adopted, do you agree they should affect actions in the UK (rather than actions governed by UK law)? If the Government seeks new legislation, should it allow the use of powers following major operational disruption affecting a non-UK major financial centre?

It is difficult to see how the extra-territorial application of any proposed legislation could extend beyond England and Wales, except where the contract is governed by UK law. However, given the IPE's general comments cited above, it is essential that this aspect of the proposals is considered further. Echoing the comments made by the Federation of European Securities Exchanges in their response, we would strongly encourage HM Treasury to explore the possibility of using this consultation as a spring-board for European and global action in this area. Given that the IPE's main competitor is US-based, the opportunity to explore whether a unilateral response to the issue of handling major operational disruption should be considered further.

Question 6l – Do you support the idea of a suspension power, subject to the constraints of paragraph 6.28?

In principle there are obvious benefits in the suspension of financial obligations, however, as highlighted in our general comments, there are considerable practical difficulties with the use of such a power. As described in paragraph 6.28, we agree that in the event that a power of suspension was enacted, that its use is limited to extreme circumstances, where there is the support of the market, and, most importantly, never used in a purely financial crisis.

Question 7a/7c – Should recognized bodies be within the maximum scope of a direction power? Should functions of institutions that are similar to the functions of recognized bodies and payment systems be within the maximum scope of a direction power?

It is crucial that any suspension or direction power extends not only to those products traded on the UK's recognised investment exchanges, but also to any trading in look-alike or OTC products which could be used for the same purpose and the Alternative Trading Systems (ATSs)/platforms where these trade. This definition should therefore be very broadly drawn (in our view in order to capture the full range of products, this should be drawn more widely than the definitions used under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001). It is also important that the legislation covers the operational elements of the market infrastructure, such as telecommunications providers which play a vital role in the operation of the UK financial system.

Question 7d – What actions should directions to infrastructure be able to order? Should directions themselves effect changes, where appropriate, or only be able to require infrastructure to take actions?

The only realistic actions which could be directed would be the temporary suspension or closure of the markets. If the power of direction was created, it is important that there is further work in advance of the use of any power with each market infrastructure provider individually and collectively in order to understand the consequences of any action taken.

Question 7e – Have you any comments about consequential effects of a direction power?

In the view of the IPE it is essential that any institution directed to act is protected from legal liability. Therefore the statement in paragraph 7.26 “it might be appropriate for a direction order to protect the users from the legal consequences of this” should be strengthened.

Question 7f – Do you support the idea of a direction power, subject to the constraints of paragraph 7.29?

Pursuant to our general comments, the IPE does not believe that the proposed power of direction is justified and therefore, irrespective of the constraints cited in paragraph 7.29, the IPE does not support the proposals to introduce a power of direction.