

21 September 2009

Chairman Mario Draghi  
Financial Stability Board  
c/o Bank for International Settlements  
Centralbahnplatz 2, CH-4002 Basel

Dear Chairman Draghi,

As the leaders of the world's financial exchanges, we would like to address some thoughts to the G20 heads of government as they prepare for their meeting in Pittsburgh.

### **Value of the Exchange Market Model**

Throughout the current financial crisis exchanges and clearing houses have delivered continuous access for all investors to transparent and well-regulated marketplaces and, in doing so, have provided stability and confidence to a sorely tested financial system. The prices of financial instruments have been disseminated despite high trading volume, increased volatility, the deteriorating risk profile of many financial organizations, and the difficulties experienced in pricing collateral.

This success has been achieved because exchanges and clearing houses operate under time-tested rules, regulations and business practices, which ensure:

- Transparency of price discovery
- Neutrality of the exchange position (neither a buyer nor a seller)
- Open access of all participants
- Timely disclosure of material corporate information
- Market surveillance
- Certainty of order execution, clearing and settlement
- Prudential margining by the clearing houses
- Dispute resolution processes

The G20 has recognized the value of the exchange and clearing house environment. Our market model has been recommended as a solution to the OTC markets. In response, the exchange industry has devised ways to add certainty to at least some OTC transactions without taking on risk which might compromise the safety and financial soundness of existing operations. More standardization of OTC contracts should also lead to exchange trading of these instruments. For this to happen, however, capital rules for banks and broker/dealers should recognize a reduced capital charge or haircut for transactions traded on an exchange and cleared in an independent, multilateral clearing house. Exchanges welcome this enhanced role, and believe that extending the certainty of their business practices will be beneficial for all market participants.

## **WFE's Current Concerns**

We recognize that due to systemic risk problems elsewhere in the financial services sector, the functioning of exchanges has not been a high priority for global policy-making bodies. However, the environment of exchange trading has been altered, and in some ways has been adversely affected by many of the changes that have occurred in the world's financial system in recent years. Therefore, the continued proper functioning of regulated exchange markets should not be taken for granted.

There are two interconnected concerns of exchanges which merit the attention of G20 leaders. First is the absence of a level playing field between exchanges and other entities performing some of the same or similar functions. Second is an erosion of price discovery arising from recent trends. As discussed below, these phenomena may be compromising the role of the public, regulated marketplace, and hampering exchanges' ability to fulfill their macroeconomic role.

### **Absence of a Level Playing Field**

In many jurisdictions, the introduction of alternative order execution platforms has led to significant internalization of order flow and related practices. These practices limit the visibility of orders, hampering investors' ability to respond to them and diluting the price discovery process. These practices also reduce the market participants' and regulators' ability, in many instances, to see overall market activity and may impact the conduct of proper market surveillance.

As the former director of the US Securities and Exchange Commission's Division of Trading and Markets has pointed out, "we want the benefits of competition, but without the adverse effects of fragmentation." The World Federation of Exchanges' Board of Directors supports the benefits of competition, but acknowledges that fragmentation, if not properly managed, may have harmful effects on market efficiency, financial stability and investor protection. A central and transparent price discovery process is at the heart of every sound market whereas fragmentation, when its design facilitates a lower level of transparency, hinders this process.

At the end of the day, all investors need to have confidence in the reliability of information reflected in the prices at which securities transactions occur. The heightened opacity of certain trading venues in many countries inhibits price discovery and may lead to negative outcomes, including increased market volatility.

The WFE Board believes that the current environment is creating an unequal distribution of the costs of providing a capital markets infrastructure at the expense of regulated markets and to the advantage of alternative trading venues. Regulated exchanges welcome competition, but it should not be structured in ways that can affect the quality of market operations and the soundness of the price discovery process. There have been new entrants with distinctive business models that have made significant contributions to our industry. The exchange industry is open to newcomers but it should be on a level playing field.

*The WFE Board recommends that the G20 leaders consult with investor organizations about how they would wish to see orders executed in the markets, and determine whether alternative trading venues have reducing the total costs of transacting by investors.*

*The WFE Board also asks G20 leaders to assure a level playing field for the responsibilities assumed by all securities order execution venues. This would remedy many capital markets uncertainties, assuring greater transparency, greater fairness, and a more level competitive field.*

### **Reduced Market Transparency: Impact of Dark Pools**

Many types of participants interact on exchanges every day, each with specific needs and objectives. Exchanges have to accommodate these varying demands while trying to assure fair access to the price discovery mechanism.

One question which has arisen is the right of markets participants to trade without providing visibility on prices and quantities to other market participants, in order that their orders are executed without moving the market against them. Recently, some exchanges have accommodated these demands by creating order types or opening segments that allow trading that is not immediately visible to the rest of the market. In the case of exchanges, this trading is nonetheless tied into the visible market's surveillance and position-monitoring in order to assure the oversight of total market operations.

Other execution venues also offering dark trading in so-called "dark pools," but their trading and clients' positions are not visible for surveillance purposes. Regulators have no way to evaluate the risks which may be inherent in the combined on-exchange/off-exchange dark pool activities, nor what effects they might have on the visible markets.

Taken together, the combination of the absence of a level playing field between execution venues and decreased market transparency is an unsettling development. The policies and practices that exchanges have developed to ensure fair, orderly markets are at risk of becoming less meaningful and less available to investors and listed companies.

The OECD's report on "The Role of Exchanges in Corporate Governance," published in July 2009, analyzes the industry's position in the light of the public good exchanges provide, specifically with respect to issuers of securities. OECD deems this work essential for a market economy, and for the success of enterprise. The OECD refers to the questions of other execution venues, some of them dark, and raises the question of what this means for the exchange and central price discovery. The OECD sees the dilemmas exchanges face, and also raises the question of how market quality is to be funded if exchanges alone are responsible for meeting their regulatory responsibilities while losing ever more revenue to unregulated entities.

*The WFE Board asks that G20 reflect upon these issues and take remedial action in those countries concerned.*

### **WFE, the Financial Stability Board, and global financial standards bodies**

In conclusion, the World Federation of Exchanges' Board of Directors would like to express its support for many of the capital markets reforms being circulated by the Financial Stability Board (FSB), including those shared by FSB Chairman Draghi at the IOSCO Annual Meeting in June. In principle, the directions set out by FSB seem correct and productive, most importantly in reducing opacity in the financial system. Issuers and investors benefit from enhanced transparency.

WFE also supports the FSB objective of having independent financial standards bodies set norms for our global financial system; we have long been at work with several of them. In October 2000, WFE members endorsed the IASB's international financial reporting standards, together with the public oversight processes that will maintain their robustness and pertinence. In October 2006, WFE exchanges endorsed the IAASB's audit and assurance standards, and their public oversight and review processes. WFE has served for several years as an advisor to the OECD on the Principles of Corporate Governance and in 2008 the WFE General Assembly voted its support for these Principles. And for the last two decades ago, the local supervisory authority's relations with IOSCO, and its support of IOSCO principles of regulation, have been a component of the inspection process for each new candidate exchange.

*WFE would emphasize to G20 leaders the need for worldwide implementation of capital market reforms in ways that will avoid regulatory arbitrage.*

Since the first months of the financial crisis, the World Federation of Exchanges Secretariat has regularly made itself available to the Financial Stability Board as an information resource on exchange-operated markets. We stand ready to continue to play this role and to assist in any way that we can in the reform and rebuilding of the global financial system.

Please do not hesitate to contact the WFE Secretariat, or to contact me directly, as you proceed with this vitally important work.

Sincerely,



William J. Brodsky  
Chairman  
World Federation of Exchanges

Copies: Svein Andresen and Benjamin Cohen, FSB  
Jane Diplock, Kathleen Casey and Greg Tanzer, IOSCO  
Angel Gurría, Carolyn Ervin and Mats Isaksson, OECD  
Robert Bunting and Ian Ball, IFAC  
Sir David Tweedie, IASB  
Jean-Claude Trichet and Mauro Grande, European Central Bank

Listed below are the members of the WFE Board of Directors:

William J. Brodsky  
WFE Chairman  
Chairman and Chief Executive Officer  
Chicago Board Options Exchange

Paul Chow  
WFE Vice Chairman  
Chief Executive  
Hong Kong Exchanges and Clearing

Huseyin Erkan  
Chairman of the WFE Working Committee  
Chairman and Chief Executive Officer  
Istanbul Stock Exchange

Antonio J. Zoido  
Chairman  
BME – Spanish Exchanges

Maged Shawky Sourial  
Chairman  
The Egyptian Exchange

Jung-hwan Lee  
Chairman and Chief Executive Officer  
Korea Exchange

Gilberto Mifano  
Advisor to the Board  
BM&FBOVESPA

Luis Téllez  
Chairman of the Board  
Bolsa Mexicana de Valores

Russell M. Loubser  
Chief Executive Officer  
Johannesburg Stock Exchange

Massimo Capuano  
Deputy Chief Executive Officer  
London Stock Exchange Group

Sandy Frucher  
Vice Chairman  
The NASDAQ OMX Group

Ravi Narain  
Managing Director and Chief Executive  
Officer  
National Stock Exchange of India .

Duncan Niederauer  
Chief Executive Officer  
NYSE Euronext

Jean-François Théodore  
Deputy Chief Executive Officer  
NYSE Euronext

Geng Liang  
Chairman of the Board of Governors  
Shanghai Stock Exchange

Thomas A. Kloet  
Chief Executive Officer  
TMX Group

Atsushi Saito  
President and Chief Executive Officer  
Tokyo Stock Exchange Group

The WFE is an association of 51 of the world's largest regulated exchanges. Information may be found on [www.world-exchanges.org](http://www.world-exchanges.org).