NASDAQ OMX[SM]

Basel Committee on Banking Supervision

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NASDAQ OMX's comments to the Basel Committee's consultative document on the capitalisation of bank exposures to central counterparties, December 2010

First of all, NASDAQ OMX would like to thank the Basel committee for their time and effort, including their gathering of responses from across the market, and we acknowledge the difficult task that lies ahead. In our view, simplicity, plus a well-orchestrated effort amongst international, regional, and national regulatory bodies will be the key to allowing our future regulations to be effective in the long term.

We have understood that the CPSS-IOSCO standards on CCPS are expected to be published for consultation within the near future. These standards should be considered within the frame of capitalization of bank exposures to CCPs. We therefore recommend an additional consultation period.

The NASDAQ OMX group delivers trading, exchange technology, listings and other public company services and post-trading services across six continents. It lists approximately 3,600 companies from 50 countries and from all industry sectors. NASDAQ OMX offers various capital raising and trading solutions to companies around the globe, including its U.S. listings market, NASDAQ OMX Nordic, NASDAQ OMX Baltic, First North, U.S. 144A, NordPool and N2EX. NASDAQ OMX Nordic and Baltic include exchanges in Stockholm, Helsinki, Copenhagen, Iceland, Tallinn, Riga and Vilnius. NASDAQ OMX offers trading across multiple asset classes including equities, derivatives, debt, commodities, structured products and ETFs. NASDAQ OMX also offers post-trading services in the form of central counterparty derivatives clearing. NASDAQ OMX technology supports the operations of about 70 exchanges, clearing organizations and central securities depositories in more than 50 countries

NASDAQ OMX broadly supports the spirit of regulatory reform, especially with regards to the improved surveillance and risk management standards of OTC derivatives. Putting the recent market events in perspective and considering the different mandates of central clearing houses versus banks in the financial marketplace, it is clear that central clearing houses have historically managed risk (including counterparty, operational, and market risks) in an exemplary fashion.

From a counterparty and market risk standpoint, we believe that at the heart of this success are a set of simple rules requiring: a) all participantsto post a adequate amount of margin collateral on a daily basis, b) new entrants to post either base collateral, c) the establishment of

adequate financial requirements for membership, and d) the clearing house to set margins, and thus control systemic leverage, with a healthy degree of independence from the members. From an operational standpoint, we believe that clearing houses were successful in shielding members from unforeseen derivatives losses by broadly utilizing standard "vanilla" contracts, simple derivative payoff structures, and liquid, easy-to-value underlying assets to those derivatives.

From a capital standpoint, IOSCO recommendations that apply to CCPs are extremely easy to grasp: CCPs need to be capitalized sufficiently to cover, at the very least, the largest exposure, or preferably the two largest exposures,[1] where exposures are measured by setting market risk levels at extreme, but plausible market conditions. Following this rule, CCPs have implemented very diverse exposure methodologies under the close supervision of local authorities.

By contrast, we regard the proposed Basel III exposure methodology (CEM) coupled together with the risk weight approach, to be inadequate for use by CCPs in many respects. CEM is imprecise as it measures market risk by categorizing products into very broad asset classes. It is rigid and inaccurate as it utilizes pre-tabulated market risk levels for each asset class, and the dependency of such levels by maturity buckets does not properly account for the CCP's daily or intra-day margin calls, or the actual volatility pattern of commodity markets. We believe that the largest problem with such a framework would be the consequences of having *two distinct exposure methodologies* within all CCPs: one exposure methodology used for regulatory capital, mandated by IOSCO and tested through the last financial crisis, and another exposure methodology for Basel compliance (the "hypothetical capital"), to be submitted by CCPs and utilized by banks. We believe that such a duplicative ruling would result in widespread confusion as to which methodology truly represents the risks within each CCP.

Furthermore, the proposed Basel calculation methodology inadvertently sets rules on which collateral is eligible for the CCP to offset exposures, by referring to collateral rules from Basel II, some of which were originally conceived for banks' repo contracts.

Particularly on the issue of eligible collateral and risk weights, the proposed Basel regulation will likely have the unintended consequence of discouraging the use of CCPs; precisely the opposite intention of the G-20 declaration.

Specifically, the proposed Basel ruling would penalize banks that contribute default funds to the NASDAQ OMX Nordic Commodities Clearing House, due to the exclusion of Letters of Credit and Bank Guarantees as eligible collateral.

Our Nordic Commodities Clearing House has an exemplary diverse membership which includes large electricity production, energy exploration, and energy distribution companies as key market participants and liquidity providers. Moreover because of the relationship between critical infrastructure (electricity grid) and the need for energy derivative trading and clearing, large commercial end-users, not financial clearing members, are the dominant players in this CCP. Commercial end-users hedge a portion of their electricity price risk using forward contracts. Currently, these commodity producers rely heavily on Bank Guarantees for margins, but they represent a *right-way risk* for the CCP, as their portfolio is fully hedged with a fraction of their commercial exposure. Furthermore, such commercial commodity producers do not possess the same levels of pledge-able liquid assets, or are heavily regulated entities in some regions so they may not be legally allowed to contribute to a default fund in the form of securities or cash. Requesting undue amounts of cash from electricity producers would also have the side effect of encumbering cash that

[1] It should be noted that the current EMIR proposal stipulates that a CCP should be sufficiently capitalized to cover the exposures from the two largest exposures.

would otherwise be utilized for other business purposes, such as infrastructure development and energy research. Such restrictions and systemic considerations may indeed place substantial limitations on the type and amount of liquid collateral these participants have available to post to the clearinghouse making the use of Bank Guarantees a necessity for maintaining an efficient CCP clearing.

Not only would the exposure of the CCP to such commodity producers be unduly penalized due to the exclusion of Bank Guarantees as collateral, but also, the proposed hypothetical capital makes no distinction between *right-way risk* to commercial hedgers versus counterparty risk to financial entities. Therefore, if and when risk-weights are implemented at all, we believe it is sensible to risk-adjust exposures to commercial hedgers by reducing the risk weights relative to similarly rated financial entities, by a significant factor. The benefit of implementing a lower risk weight to commercial hedgers would be to create incentives to use CCPs, which is the actual goal of the G-20 declaration. A preferential risk weighting for commercial hedgers would mean that right-way risk is transparently segregated, and is visible to both regulators and CCPs. Contrast this with a commercial hedger's trades through OTC, which at best would end up in the CCP as part of a market-makers' omnibus account, and therefore *right-way risk* would be indistinguishable from speculative portfolio exposures. Thus, our view is that proper risk weights for commercial hedgers with a demonstrated commercial exposure and suitable credit profile would encourage the use of CCPs and contribute to greater transparency in the financial system.

With regards to the actual levels of charges proposed for banks on CCP exposures, our opinion is that it is important that the relative levels are defined appropriately in order to avoid any incentives to allocate too much margins relative default fund capital. There could be a risk that the current ruling would negatively disturb the balance between capital (which can be utilized for all loses to the CCP) and margins (which the CCP can only apply towards one member's losses). If the proposed ruling would favor margins and penalize capital, it could have unintended consequences for financial stability, as it would encumber funds set aside to protect against systemic risk. This would encourage CCPs to fund capital themselves and reduce the alignment of interest between CCPs and member banks. If a charge is to be implemented, it must be applied neutrally between margins and default fund contributions, such that the equilibrium between the two is not unduly influenced either way. What the appropriate level should be must be analyzed further, which has not been possible due to the limited time frame.

If the capital charge levels for default fund contributions are too high, and their potential range too large, it might create unintended negative impact in the markets. We emphasize that default funds constitute the CCP's *capital*. It is of great importance that the CCP has a good balance between margins and default fund capital and thereby maintain a substantial part of the capital in the control of the CCP, which shields against systemic risk in the financial markets, rather than picking it apart into each member's regulatory capital, which shields each member and does not protect the broader market. This is a clear rational to maintain the strong regulatory framework around CCPs, which was successful through the crisis, rather than charging banks for contributing to CCP capital. CCPs should be structurally strong enough and their members should be sufficiently invested in the CCP that counterparty charges should not be necessary in our view.

In addition to the aforementioned, we would like to make the following comments.

- We are as a clearinghouse assessed by our regulators under the ESCB/CESR Recommendations for Central Counterparties in the EU, May 2009. You refer in your proposal only to the CPSS-IOSCO standards when discussing the concept of "qualifying CCP". For avoidance of doubt, we suggest that you clarify that compliance with the ESCB/CESR recommendations would be equivalent and sufficient to be treated as a "qualifying CCP".

- As noted above, a "qualifying CCP" shall be a CCP complying with CPSS-IOSCO standards and being able to assist clearing member banks in properly capitalizing for CCP exposures. We believe it would be beneficial to clarify what is meant with complying with CPSS-IOSCO standards. In particular considering that the assessment categories for each recommendation are divided into several categories, like for example compliant, materially complied with and partly complied. Should the conclusion be that a CCP can only be considered a "qualifying CCP" if all 15 recommendations are fully complied with? We would find such a conclusion to be unreasonable and not justified.

- Furthermore, a CCP may perhaps not be assessed by its regulators under ESCB/CESR recommendation No 15 due to the assessor and regulator being the same entity. This is the case for NASDAQ OMX. Our regulator does not assess recommendation No 15. We are also not assessed under recommendation No 11 due to the fact that we currently do not have a link with another CCP. It would not be rationale to exclude NASDAQ OMX as a "qualifying CCP" due to this considering the objectives of your proposal. We recommend that you consider clarifying your proposal in this respect.

Finally, it should noted that we fully support the EACH (European Association of CCP Clearing Houses) response letter, which we were able to agree with in its draft form, and which we understand will be received by the Basel Committee as part of this consultation process.

NASDAQ OMX

Kind regards,

Magnus Billing

Chief Legal Counsel