

Interoperability

Executive summary

Interoperability is a mechanism for introducing competition and freedom of choice at each stage of a securities market transaction. At present, the vast majority of cash equity markets require their users to make their trades, clear them and settle all on specific market platforms. This creates unnecessary cost and removes the incentive for quality of service to be improved through competition. Interoperability would allow market users to choose their preferred supplier for each step of the transaction process.

AFME is a strong supporter of choice and competition and believes that appropriately-framed interoperability arrangements for cash equities would significantly increase competition and efficiency in the European securities markets, without increasing risk.

The Code of Conduct on Clearing and Settlement defines interoperability as a key objective, alongside price transparency and the unbundling of services. AFME calls on public authorities and regulators to encourage the achievement of this third objective. AFME also notes that the recent Proposal for a Regulation on OTC derivatives, central counterparties (CCPs) and trade repositories includes a chapter on interoperability and welcomes its inclusion. We urge regulators to ensure that this chapter is reflected in the final Regulation.

Overview

Scope

Since publication of the Code of Conduct on Clearing and Settlement in 2007, users have concentrated on the ability to choose a CCP for cash equity clearing and how regulatory requirements should be met in order to progress interoperability. Members have actively pursued this objective with their cash equity clearing providers and trading venues in the context of the Code of Conduct. Some progress has been made – interoperability, under the label ‘Competitive Clearing’, exists today between LCH.Clearnet Ltd and SIS X-Clear, for example.

Against the background of the ongoing regulatory reviews of the proposed interoperability arrangements between LCH.Clearnet Ltd, EuroCCP, EMCF and SIS X-Clear, **AFME members continue to be strong advocates of increased competition in the European cash equity clearing markets.** In particular we support demand-based CCP interoperability, as set out in the August 2009 ‘Interoperability Statement’ document, from the regulators of the UK, Switzerland and the Netherlands, and in the European Commission’s October 2009 ‘Review of Code of Conduct’ documents.

Interoperability would enable users to consolidate clearing arrangements at fewer CCPs, allowing significant benefits in terms of risk management and cost efficiency. Cash equity trades in the same security, dealt on several trading venues, could be netted into a single obligation for settlement at the home central securities depository (CSD). The number of payments to margin and default funds would reduce contrasting with existing arrangements, where participants contribute to multiple funds depending on the CCP chosen by the trading venues. This process need not impose costs on those members that wish to remain with the incumbent.

Appropriately framed interoperability arrangements will significantly increase competition and efficiency in the European cash equity markets and can be constructed in a way so as to not to increase risk and ultimately could benefit end investors such as pension funds.

Required public sector action

Although AFME supports the inclusion of interoperability in the European Commission Proposal, members are not asking for interoperability of derivatives at this stage. The focus is on establishing interoperability in the cash equity sector.

However, it is worth remembering that the Code consisted of three parts: price transparency, interoperability and unbundling of services. Only two of these objectives have been met. It would seem inconsistent to remove the very wording that would permit full implementation of the Code in accordance with the wishes of the European Commission. **We believe it would be wrong to remove the entire interoperability chapter from the Proposal**, as has been suggested.

AFME's position on Interoperability

- AFME and its members are **strong supporters of choice**, and hence interoperability, to address the issue of fragmentation in the cash equity clearing space.
- There are **genuine efficiencies** to be gained by consolidating transactions into fewer CCPs at both the clearing and settlement layers.
- We **support robust arrangements for the management of risk** by the CCPs.
- AFME **welcomes the inclusion of interoperability in cash equities in the European Commission's Proposal** for a Regulation on OTC derivatives, CCPs and Trade Repositories. No other proposed legislation encompasses this field.
- The **proposed recent trading venue mergers may lead to larger vertical structures** that would further preclude the element of choice for users in the post-trade arena.

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