SIFMA
European Securities Services Forum

LIBA
LONDON INVESTMENT
BANKING ASSOCIATION

MARKET USER REVIEW
OF
EUROPEAN CODE OF CONDUCT
FOR
CLEARING & SETTLEMENT

INTRODUCTION AND KEY MESSAGES

1. Representing the main users of European post-trading services, the London Investment Banking Association (LIBA)[1] and the European Securities Services Forum (ESSF)2 set out in this paper, our review of the implementation of the European Code of Conduct for Clearing and Settlement.

2. We continue to believe that there is a role for focused industry action to complement the efforts of the public authorities. We have supported the European Commission's work in establishing a clearing house for credit default swaps and note that here too, the benefits of the non-legislative approach are apparent.

3. LIBA and ESSF were heavily involved in developing the policy framework which led to the formulation of the Code of Conduct. As the main users of the market infrastructure providers, our members continue to be concerned with market structure issues and the need to continue to develop safe, efficient and internationally attractive financial markets in the EU.

4. Three years on from the signing of the Code of Conduct (November 2006) and nearly two years on from its full entry into force (beginning of 2008), market users consider this an appropriate point to take stock, setting out our assessment of the extent to which the Code of Conduct has been successfully implemented and our proposals for making further progress towards the agreed goals. Moreover, we are aware that the Swedish EU Presidency has charged the European Commission with compiling its own progress report on the Code of Conduct. We would appreciate the Commission taking our views into consideration as it drafts this report.

5. The structure of our Review reflects that of the Code of Conduct: For each of its three components we analyse the extent to which the Code of Conduct has been implemented and set our proposals for addressing the shortcomings identified. For each section, a summary is

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[1] LIBA is the principal trade association in the United Kingdom for firms which are active in the investment banking and securities industry. The Association represents its members on both domestic and international aspects of this business, and promotes their views to the authorities in the United Kingdom, the European Union, and elsewhere. Its website is www.liba.org.uk. LIBA is registered with number 84360841127-33 in the Commission's Register of Interest Representatives; please see: https://webgate.ec.europa.eu/transparency/regrin/consultation/displaylobbyist.do?id=84360841127-33

[2] The ESSF is the European post-trading centre of competence of the Securities Industry and Financial Markets Association (SIFMA). Its members (see Annex) are the major users of international securities markets. Representing its members as towards market infrastructure organisations and public authorities, the ESSF acts as an agent for change providing and supporting solutions in the securities clearing, settlement and custody space to reduce risks and costs to market participants.

followed by a more in-depth analysis. The conclusion summarises the points made and reaffirms our commitment to the Code of Conduct.

6. On **Price Transparency**, we acknowledge the significant increase in price information and welcome the efforts to improve price comparability but remind the market infrastructures of the need to maintain transparency in rapidly changing price environment and of the need to deliver better holistic data, more efficiently and within a framework agreed with users that pay the fees.

7. On **Access and Interoperability**, we acknowledge the progress made so far in the implementation of access and interoperability links. However, we are disappointed that progress on this core part of the Code of Conduct is with exception of the LSE and SIS Swiss Exchange largely limited to the clearing of trades on MTFs and two Nordic exchanges. We ascribe this lack of progress to the continued opacity of the link-request process; to indefensible regulatory barriers; and to the vested interests of incumbent infrastructure providers.

8. On **Service Unbundling and Accounting Separation**, we are informed of the efforts of the market infrastructures to document their compliance with this part of the Code of Conduct but are frustrated by the lack of transparency of this documentation which prevents market users from conducting any independent monitoring. We think it should be clear from the published annual accounts that the infrastructures have discharged their obligations under the Code, even if the material filed with the national regulator is not made available to market users. We think there should be a presumption that infrastructures *not* making these statements should be subject to more intrusive supervision. Moreover, we would welcome the opportunity to give our views on the issues in more detail.

PRICE TRANSPARENCY

9. We believe that the Code of Conduct has led to a significant increase in price transparency across all market infrastructures and that this has shifted attention to price comparability. In response, ECSDA has developed conversion tables which we consider a useful tool for improving comparability. We acknowledge that the different business models of infrastructure providers present inherent limits to comparability but recommend that this can be improved through the increased use of price simulators. While we are much encouraged by the progress being made on price transparency we would remind infrastructure providers to maintain that transparency not least in the context of the trend towards increasingly frequent price changes. In addition, to ensure a more meaningful picture of the evolving pricing landscape, we strongly encourage service providers to publish their prices on a ‘basis point’ as well as ‘per trade’ basis.

10. We acknowledge and welcome the significant increase in price transparency across all market infrastructures brought about by the widespread publication of information on e.g. fees, discount and rebate schemes, and price examples. However, while there is now much more information on the prices of service offerings of individual market infrastructures, the data is often complex and difficult to compare with that of competing service providers, especially in the settlement area. We therefore welcome the efforts of the CSDs to develop conversion tables to improve price comparability and encourage ECSDA to continue to update these in light of changes to the service/price offerings of its members. We will channel our comments on the evolving conversion tables directly to ECSDA.

11. While conversion tables help improve price transparency, they do not achieve full comparability. Fundamental differences in business models and consequently the services being compared place inherent limits on price comparability. However, we believe that comparability can be improved from their current level by means of price simulators where an

interactive platform allows users to calculate in real time the costs of the various services of a given provider. We recognise that simulators are not required by the Code of Conduct and are therefore appreciative of the efforts of a number of infrastructure providers to develop such mechanisms. Referring to the ECB survey on price simulators of May 2009[3] it is clear that these are not yet in wide use and that where they are available, they may lack sophistication in terms of e.g. scope and ease-of-use. We believe that simulators have the potential to improve transparency and therefore encourage market infrastructures to continue to develop these mechanisms and to make these widely available. We will channel our comments on the evolving price simulators directly to FESE, EACH and ECSDA.

12. Although significant progress has and continues to be made to improve transparency, we would highlight that 'slippages' have and do occur; e.g. the introduction of new tariffs prior consultation. In light of the current trend toward more frequent price changes, we encourage infrastructure providers and their associations to maintain comprehensive price transparency, including the timely communication of price changes.

13. Moreover, we highlight the importance of providing price data using meaningful/comparable metrics. In particular, we reiterate our position (set out in our 15-05-09 meeting with DG Market) that sole reliance on the 'cost/trade' metric may be misleading as it is biased by different average trade sizes on trading venues and trends towards shrinking trade size. We believe that 'basis points' may in many instances be a better metric reflecting post-trade costs as a proportion of the respective value-traded. We believe that the EU Commission can assist by encouraging market infrastructures to provide value-traded as well as cost/trade in invoices. In addition, we emphasise the importance of efficient invoice processing, e.g. in electronic format, including spreadsheet overview, and according to an agreed delivery schedule.

ACCESS AND INTEROPERABILITY

14. The access and interoperability provisions have the potential to provide real competition and user choice and are as such the key part of the Code of Conduct. We acknowledge and welcome the progress made so far in the implementation of access and interoperability links. However we are disappointed that progress is, with the exception of UK and Switzerland largely limited to the clearing of trades on MTFs and two Nordic exchanges. We ascribe this lack of progress to the lack of transparency of the link-request process and to indefensible regulatory and commercial barriers.

15. We consider the access and interoperability provisions as the core part of the Code of Conduct because they are a means of driving real competition and user choice without which the price transparency, service unbundling and accounting separation will be of very limited benefit. In the context of access and interoperability, we attach greatest importance to the creation of a competitive environment for CCP services for cash equity products at the major European securities exchanges, as a means of mitigating risk, reducing frictional cost and stimulating innovation. In this context we note that CCPs should never compete on the basis of risk management standards.

16. With respect to the availability of CCP services for cash equities, we acknowledge and welcome the progress made so far in implementing the access and interoperability provisions of the Code of Conduct. We attach for your information, Annex 1 setting out our analysis of the current CCP access and interoperability landscape in Europe in terms of the markets where CCPs already provide services or are scheduled to do so within the next six months (The Annex is an updated version of the UBS document sent by the ESSF/LIBA to DG Market on 06-08-09).

[3] Link: [http://www.ecb.int/paym/groups/pdf/200905price_simulator.pdf?c0ca9da9ed657f25ca1ee38a88dd569e]

17. In terms of CCP interoperability, it is clear from Annex 1 that significant progress has been made in relation to the MTFs with e.g. Chi-X MTF, Turquoise MTF and BATS Europe MTF all either already delivering competitive clearing solutions or planning to do so within the next three months. A clear concentration of progress is also evident in the Nordic region where e.g. NASDAQ OMX and Olso Bors plan to introduce competitive clearing - albeit on a mandatory sequential basis (see below under 'Business Practice Barriers') - in the next six months. Annex 1 also reflects the introduction of competitive clearing in relation to the LSE and SIX Swiss Exchange.

18. However, in the remaining key markets, progress towards CCP interoperability has been very slow or non-existent. Annex 1 shows that only limited progress has been made in relation to e.g. Deutsche Borse (where Eurex Clearing will only interoperate/compete with SIS x-clear) and NYSE Euronext (where interoperability between LCH.Clearnet SA and SIS x-clear is yet to be confirmed). In other important markets such as Italy and Spain, there has been no progress whatsoever.

19. We believe that the lack of progress on CCP interoperability can be ascribed to a combination of: insufficient transparency [at least as towards market users] of the link request process; regulatory and supervisory barriers; and the commercial interests of incumbent exchanges and CCPs.

Process Transparency

20. We are disappointed that the process by which requests for access and interoperability are made and handled remains opaque, making it difficult to ascertain whether and where progress is being made and on that basis verify that efforts are being appropriately prioritised. We do acknowledge the efforts made by market infrastructures to improve the transparency of the access and interoperability process: The reporting template used by infrastructure providers to update the MOG on the progress of requests for access and interoperability has improved transparency albeit from a very low base. However, the information reported is very high level and omits important data, including: accurate time-stamping and evidence of any user input/comment. It therefore remains hard to gauge whether and where progress is being made, and where it is not, the reason (e.g. commercial, technical, regulatory, or public policy) for this.

21. The need for greater transparency is amplified by the multitude of requests for access and interoperability. Even if link requests are considered in terms of sets rather than as individual applications, this leaves a large number (30+) of request sets and consequent need to prioritise them. The lack of transparency of the request process and particularly on the extent to which requests are supported by user demand makes is very difficult to determine whether requests are appropriately prioritised. While the 'first come first served' principle may have provided a useful initial basis for such prioritisation, we believe that this principle needs to be modified by a measure of the extent to which the request is supported by user demand. In practice we believe that this will lead to a prioritisation of link requests made between e.g. the French, Spanish, German and UK markets.

22. In addition, we believe that the concept of 'business case' in the access and interoperability context is too vague and allows market infrastructures that receive link applications too much flexibility in terms of rejecting requests on business case grounds. We would like to remind the Commission of its undertaking at the MOG meeting of 3 February 2009[4] to develop a discussion paper setting out its understanding of business case concept in the access and interoperability context.

[4] Link: http://ec.europa.eu/internal_market/financial-markets/docs/code/mog/20090203_report_en.pdf

23. To address the above weaknesses in process transparency, we propose that the reported data be enhanced as described above: i.e. through inclusion of evidence of meaningful input by affected users and accurate time stamping of all data points. In addition, we propose that the wider user community be given at least two weeks to review the market infrastructure report in advance of its presentation at the MOG meeting.

Regulatory and Supervisory Barriers

24. The provisions of Articles 33 and 37 of the Code, which require compliance with the legal, fiscal and regulatory arrangements applicable to the incumbent infrastructure providers have not been conducive to a timely implementation of the access and interoperability provisions of the Code. In a number of EU jurisdictions, the regulations and/or supervisory practices applying to market infrastructure providers create barriers to access and interoperability.

25. For example, the French Monetary and Finance Code Article L.442-1[5] requires any firm providing clearing and settlement services to an investment exchange in France to be an EEA regulated credit institution with authorisation to provide such services in France. This restriction creates a regulatory obstacle to entry to the French market for clearing service providers irrespective of whether these have the appropriate regulatory authorisations in their home Member States to provide clearing services. We consider that the French regulatory restrictions curtail competition between CCPs and ultimately increase costs for investors in securities markets. We believe that so long as a CCP domiciled in a Member State has satisfied its regulator that it meets that regulator's requirements for regulatory approval and operates under international standards, there should be no further requirement to obtain local licences in the Member States in which the CCP wishes to provide clearing services.

26. While some jurisdictions have taken steps to mitigate the anti-competitive effects of their regulations, this piecemeal treatment of symptoms does not remove the barriers in question. For example, we welcome the BaFIN's decision to exempt certain CCP service providers (i.e. LCH.Clearnet Ltd, LCH.Clearnet SA and SIX x-clear) from the German Banking Act requirement to hold a German banking license. However, we would emphasise that rather that removing a significant barrier to competition, the exemption approach merely provides a narrow and potentially uncertain opening in it. The granting of an exemption is entirely dependent on the BaFIN's assessment of whether a need for additional (German) supervision exists in connection with the conduct of CCP services.

27. We advocate the timely removal of regulatory barriers to access and interoperability. In this respect we refer to the CESR advice to the European Commission of February 2009 which focused on mapping the differences between Members States in their approach to the regulation of clearing and settlement and encourage CESR to on this basis further develop its recommendations for addressing the differences identified.

Commercial Barriers

28. The commercial interests of the incumbent infrastructure providers may also create barriers to access and interoperability.

29. For example, in Scandinavia, NASDAQ/OMX has committed to introducing a CCP (EMCF) on a mandatory basis in October 2009 and EMCF has subsequently committed (see June 2009 announcement by EMCF) to achieve interoperability for the Nordic markets with EuroCCP and SIS x-clear by January 2010. Similarly, we understand that Oslo Boers intends to introduce it own CCP (Olso Clearing) in the near future before offering interoperability with a number of other (yet to be determined) CCPs at a later stage.

[5] Link: http://195.83.177.9/upl/pdf/code_25.pdf

30. We are disappointed that neither NASDAQ/OMX, nor Oslo Boers will offer interoperability at the point of mandating CCP clearing by EMCF and Olso Clearing, respectively. Users of NASDAQ/OMX that are not already participants of EMCF and all users of Oslo Boers (who by definition will not be participants in the yet-to-be-launched Olso Clearing) will need to incur the costs of participation in the respective CCP either directly or though a general clearing member. These sunk costs will act as significant barrier to incurring the additional costs of later participating in the interoperable CCPs providing the EMCF and Olso Clearing with an unfair competitive advantage. While we appreciate the operational challenges of a 'big bang' approach to the introduction of competitive clearing in an environment not previously serviced by a CCP, history demonstrates (for example, the simultaneous introduction of competitive clearing arrangements for the Virt-X Stock Exchange) that these are not insurmountable. We remain keen to see the introduction of competitive clearing progress on time to the schedule that has been committed to publically. We believe that the mandatory sequential approach to the introduction of competitive clearing runs counter to the spirit of Code. To address this issue, we suggest the Code of Conduct and/or supporting Guidelines be amended to require exchanges in markets without CCP(s) to on request, substantiated with user support, provide CCP(s) wishing to serve such markets with a transaction feed.

31. In the case of clearing of NASDAQ/OMX, we are moreover increasingly concerned that the January 2010 deadline for CCP interoperability may not be met. Market users want to see the previously announced plans for CCP competition in that market delivered.

32. If the remaining commercial and/or regulatory obstacles to progress on CCP interoperability are not removed within a reasonable time period, then enforcement action may be required.

ACCOUNTING SEPARATION AND SERVICE UNBUNDLING

33. We are informed of the efforts of the infrastructure providers to document their compliance with the accounting separation and service unbundling provisions of the Code of Conduct but we are frustrated by the lack of transparency of this documentation and by the lack of any opportunity for market users to input their views on it. We are moreover disappointed by the widespread delay in compliance with this aspect of the Code of Conduct.

34. We regard the accounting separation and in particular the service unbundling provisions of the Code of Conduct to be very important not least because they potentially strengthen the bargaining position of users vis a vis service providers. For example, Euroclear (UK and Ireland) have recently unbundled their CCP service fees enabling users to compare the costs of their services with those of competing providers.

35. While we are informed that the market infrastructures are making efforts to document their compliance with the accounting separation and service unbundling aspects of the Code of Conduct, we remain frustrated by the absence of any opportunity to provide user input on the reports and by our lack access to at least the key aspects of this documentation, including management commentary on the compliance reports. Moreover, as the forthcoming CESR update on compliance with this aspect of the Code will be limited to a statement on whether/not CESR members have received the documentation required by the Code, we consider this of very limited informational value.

36. We think it should be clear from the published annual accounts that the infrastructures have discharged their obligations under the Code of Conduct, even if the material filed with the national regulator is not made publically available. We would like to se two statements in the annual accounts, as follows: 1) 'The directors confirm that [name of company] has discharged its obligations under the Code of Conduct'. And 2) 'The auditors confirm that [statement (a)] has been made after due and careful enquiry'. We would expect the Commission and the

authorities closely to monitor progress towards producing these statements in respect of the 2009 calendar year. We think there should be a presumption that infrastructures *not* making these statements should be subject to more intrusive supervision.

37. Based on the Progress Report provided by the market infrastructures at the last (7 July 2009) meeting of the MOG, it is clear that a large number of infrastructures have been unable or partially unable to deliver the required compliance and audit reports and public statements on a timely basis. For a limited number this delay may be justified on the grounds of their reporting year being different to the calendar year, but the remaining infrastructures explained the delay on the basis that they were finding the report completion exercise difficult as they were subject to different requirements from their auditors who were generally unaccustomed to this type of auditing. We are disappointed by the delay in compliance and encourage the Commission to ensure this issue is addressed.

CONCLUSION

38. We continue to support the Code of Conduct. Despite the slow rate of implementation in certain areas (particularly with respect to CCP interoperability), we believe that this industry-led approach has resulted in far greater progress toward a more efficient and integrated post-trading market in the EU than would have been possible over a much longer period using a legislative instrument. We remain committed to working with the Commission, the market infrastructures and other stakeholders to ensure the Code of Conduct delivers its full potential on a timely basis. We stand ready to expand on any of the points raised in this Review or related thereto if the Commission would find that helpful.