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**THE CODE OF CONDUCT ON CLEARING AND SETTLEMENT: THREE YEARS OF
EXPERIENCE**

Table of Contents

INTRODUCTION	1
1. A RAPIDLY CHANGING MARKET PLACE	1
1.1. An evolving market structure	1
1.2. Impact on prices and costs.....	2
2. THE CODE'S THREE PILLARS – STATUS	4
2.1. Price transparency	4
2.2. Access and interoperability	5
2.3. Service unbundling and accounting separation.....	7
3. GLOBAL ASSESSMENT AND FUTURE OUTLOOK.....	8
CONCLUSION	9

INTRODUCTION

In July 2006, Commissioner McCreevy called on exchanges, clearing houses and securities depositories to overcome the fragmentation characterising Europe's post-trading market by committing themselves to more transparency, competition and choice. In November the same year, these central market infrastructures presented a voluntary Code of Conduct that sought to increase (i) price transparency, (ii) access and interoperability, and (iii) service unbundling and accounting separation.

In view of three years having passed since the Code was signed and this Commission's mandate coming to an end, now is an appropriate time to take stock of the effects of the Code on the ground and to conclude whether the objectives of the Code have been achieved.

This first section outlines the state of Europe's post-trade markets today. Section 2 assesses what the Code's three pillars have achieved as well as outlines the remaining challenges. Section 3 presents a global assessment and outlines the role of the Code as the new Commission takes up its mandate. A final section concludes.

The Commission believes that the Code has contributed to a significant restructuring of Europe's post-trade markets. Competition has increased and prices and costs are decreasing. This is particularly pronounced in the area of Central Counterparty (CCP) clearing. However, challenges remain, notably as regards issues related to risks and regulatory barriers to cross-border service provision. These will be addressed by the forthcoming legislation on CCPs, which was recently announced by the Commission. Even so, self-regulation and legislation remain important complementary tools and the Code will continue to have a pivotal role to play.

1. A RAPIDLY CHANGING MARKET PLACE

The post-trade systems carrying out clearing, settlement and custody in Europe have traditionally been fragmented along national lines. Many stakeholders have highlighted that this is not compatible with a single market for financial services and empirical evidence also highlight that the fragmented structure increases cross-border costs.¹ This section outlines the changes and highlights the impact on prices and costs.

1.1. An evolving market structure

The market structure for trade and post-trade service provision is rapidly changing:

- **More competitive trading:** Since the entry into force of the Markets in Financial Instruments Directive (MiFID) in November 2007, the provision of trading services has become increasingly contestable. New trading venues in the form of multilateral trading facilities have entered the market (e.g. Chi-x, Turquoise, BATS Trading Europe...) and during the course of 2008 captured significant market shares from incumbent trading venues in the form of regulated markets.

¹ See e.g. the final report of the Committee of Wise Men on the regulation of European securities markets (February 2001), the two Giovannini reports of 2001 and 2003, the European Commission communication on clearing and settlement of April 2004 (COM(2004)312) and the 2006 Draft Working Paper of the European Commission's Internal Market and Services DG.

- **Entry of new post-trade service providers:** One reason why the MTFs have succeeded this time (compared to a decade ago), is that thanks to MiFID and the Code of Conduct they have been able to offer effective post-trade solutions. Typically, the new trading venues have chosen to use newly formed central counterparties (CCPs), independent from incumbent exchanges, such as EMCF and EuroCCP. After having introduced these new platforms and having started with only one per MTF, they are now pushing for competitive clearing. For example, the CCPs serving Chi-x, BATS Europe, NASDAQ OMX Europe and NYSE Arca Europe have all agreed to become interoperable in the near future.²
- **Increased competition between incumbent service providers:** Links between incumbent operators have also progressed. In December 2008, competitive clearing for trades done on the LSE became operational, with LCH.Clearnet Ltd and SIX x-clear becoming interoperable. Since then, further interoperability agreements have been concluded between e.g. Eurex Clearing and SIX x-clear for the Frankfurt Stock Exchange (FWB) and the SIX Swiss Exchange.
- **Increasing use of CCPs:** The financial crisis has illustrated that CCP clearing is not only efficient, as it reduces the amount of transactions that need to be settled, but also effective in mitigating risk. As a result, CCP clearing is becoming more used. In equities, this is e.g. reflected by the introduction of CCP clearing for NASDAQ OMX's Nordic market in 2009.
- **Settlement restructuring:** Consolidation, links and TARGET2-Securities (T2S) have continued to reshape the settlement market structure. As regards consolidation, in December 2008, the Euroclear Group expanded by acquiring NCS D, thereby adding the Swedish and Finnish CSDs to those of France, Netherlands, Belgium, United Kingdom, Ireland and Portugal. As regards links, the Link Up Markets initiative, launched in March 2009, has currently nine active links.³ Concerning T2S, the project achieved a major milestone in July 2009 with the signing of the T2S Memorandum of Understanding between the Eurosystem and central securities depositories (CSDs). 27 CSDs located in 25 European countries (including two from non-EU countries, Iceland and Switzerland) signed up to settle euro-denominated securities in T2S. In addition to settlement in euro, the CSDs of Denmark, Lithuania and Sweden also signed up for settlement in T2S of securities denominated in their domestic currency.

1.2. Impact on prices and costs

These changes have increased competition and choice and have exercised downward pressure on prices and costs. Previous Commission services reports to the ECOFIN have documented in an ad-hoc manner how the prices and costs of especially clearing services have decreased in the wake of the restructuring of the trade and the post-trade sector outlined above. Based on a recent report commissioned by the European Commission, it

² EuroCCP, EMCF, LCH.Clearnet and SIX x-clear

³ CBF Germany, OeKB Austria, SIS Switzerland, VP Denmark, Hellex Greece, Iberclear Spain, CSE Cyprus, VPS Norway, Strate South Africa.

is now possible to more systematically analyse how trade and post-trade services are provided and how end-to-end trading and post-trading prices have evolved since 2006.⁴

The report covers the diverse picture in 18 financial centres⁵ and confirms previous findings that selling, buying or holding a security is all but simple. The market structure and trade and post-trade processes are complex, involving many types of institutions that perform the functions necessary to process a trade. This holds for domestic transactions, but even more so for cross-border transfers. This complex landscape makes it difficult to measure prices. Even so, the report contains data from the full securities trading and post-trading value chain. It provides a glimpse into how prices have evolved between 2006 and 2008 for services provided by trading venues, CCPs and CSDs.

- **Volume drives prices:** As regards the data from the full value chain covering 2006, which will form the base for future monitoring, evidence from throughout the value chain highlights that volume is the single most important determinant of unit price. While there is significant cross-border activity, domestic activity is much larger. For example, while most infrastructures have many clients from abroad, these stand for much less volume than domestic clients. Therefore, throughout the value chain, the costs of trade and post-trade services are two to six times higher for cross-border transactions than domestic ones. This confirms the findings of previous studies.⁶ Different potentials to exploit scale economies explain much of the difference, but barriers (e.g. of Giovannini kind) certainly play a role as well.
- **Costs are decreasing:** The study also highlights that costs per transaction are decreasing. As regards the data from providers of infrastructure services, which covers both 2006 and 2008, building on the diverse picture of infrastructures in 18 financial centres, the following general observations can be made. As regards trading, across financial centres, trading costs in terms of costs per transaction have decreased significantly with up to 60% since 2006. The same holds for clearing, where across financial centres, CCP clearing costs per transaction have decreased significantly – also in some cases with up to 60% - since 2006. The picture is more diverse for settlement. In many centres, CSD settlement costs have decreased but in many they have increased.

Overall, these general trends documented by the report confirm the anecdotal evidence documented in previous Commission services reports to the ECOFIN that costs are decreasing since the entry into force of the Code of Conduct. The Commission has ordered a new report, which will take further stock of these trends and will assess how these costs decreases have impacted institutional and retail investors.

⁴ Oxera (2009), Monitoring prices, costs and volumes of trading and post-trading services, http://ec.europa.eu/internal_market/financial-markets/docs/clearing/2009_07_ec_report_oxera_en.pdf

⁵ These are classified in *major* financial centres (France, Germany, Italy, Spain, Switzerland and the UK), *secondary* financial centres (Belgium, Luxembourg, the Netherlands, Norway, Poland and Sweden) and *other* financial centres (Austria, Czech Republic, Denmark, Greece, Ireland and Portugal).

⁶ See the 2006 Draft Working Paper of the Internal Market and Services DG for an overview of previous studies.

2. THE CODE'S THREE PILLARS – STATUS

This section takes stock of the Code's contribution to the changes outlined above. It reviews the Code's achievements and remaining challenges in each of its three pillars: price transparency, access and interoperability and service unbundling and accounting separation. The analysis builds on Commission's continuous monitoring of the Code's implementation. This has particularly been carried out in the context of the Monitoring Group of the Code of Conduct (MOG), which has met on a quarterly basis since the Code was signed.⁷

2.1. Price transparency

2.1.1. Achievements

The Code has significantly enhanced price transparency. All infrastructures now publish the information necessary to understand an infrastructure's service offering. This includes fees, applicable public discount and rebate schemes and information to allow billing reconcilability. All infrastructures have also made efforts to improve price comparability by means of price examples, conversion tables and – more recently – price simulators. Infrastructures have also cooperated with the above-mentioned report on prices, costs and volumes, thereby making it possible to see how prices, costs and volumes have developed since 2006.

2.1.2. Remaining challenges

These are important results. Even so, as previously highlighted by the Commission, price comparability remains difficult in view of underlying differences in business models.⁸ Comparing prices is particularly difficult in the settlement layer, where complexity is most pronounced.

Significant time has been devoted to assess the problems of comparability and to evaluate the tools brought forward by infrastructures. In view of those efforts, the Commission considers that there are three largely complementary tools that may improve comparability provided they are well designed: price simulators, conversion tables and price examples. The Commission considers that all increase transparency and contribute to comparability.

Even so, comparing prices remain difficult where infrastructures label their services differently. The reasons for this are broadly historical, as each CSD has developed its own business model in isolation, and as a result label their services differently. Full comparability would accordingly require a significant simplification and harmonisation of the way infrastructures present their services in their fee schedules. This is difficult to achieve in view of the fundamental differences in infrastructures' business model. The Commission nevertheless that further industry-led harmonisation of the definition of

⁷ The MOG consists of representatives from the Internal Market and Services DG (MARKT), the Economic and Financial Affairs DG (ECFIN) and the Competition DG (COMP) as well as representatives from the European Central Bank (ECB) and the Committee of European Securities Regulators (CESR). It is chaired by DG MARKT. The MOG holds regular meetings at which representatives of infrastructures and users attend. The summary of MOG meetings as well as presentations are available on the Commission's website: http://ec.europa.eu/internal_market/financial-markets/clearing/mog_en.htm

⁸ See Commission services reports to ECOFIN of September 2007, February 2008 and November 2008.

services, notwithstanding differences in business models, should be the priority in the short to medium term. That work could usefully build on ECSDA's report on glossary and definitions of services relevant to the implementation of the Code. Naturally, harmonising definitions does not mean harmonising business models, service offerings or prices.

2.2. Access and interoperability

2.2.1. Achievements

The most fundamental achievement of the Code is that it embodies an industry agreement on the principles of, and paths towards, open access and competition by means of links. The Code has effectively provided an industry standard, with general principles agreed in the Code and more detailed implementing rules agreed in the accompanying Access and Interoperability Guideline. The latter contains a number of important principles that have gained market recognition:

- **Standard access is a right:** Provided that there are no regulatory concerns, infrastructures that receive a request for standard access from another infrastructure should grant that access without any conditions according to Article 23 of the Access and Interoperability Guideline. Therefore, infrastructures have a right under the Code to become members of another infrastructure (e.g. pending interoperability), unless specific risk concerns have been identified.⁹
- **Reciprocity principle:** Article 50 of the Access and Interoperability Guideline states that a receiving organisation can deny a link request if the requesting organisation is itself demonstrably impeding a parallel request for a reciprocal link. The Commission considers that it is natural that if an infrastructure seeks to provide competing services in the market of another infrastructure it should at the same time strive to ensure reciprocal market access to the market it is currently clearing.
- **Business case:** A loss of market share is not a valid excuse for refusing a link request. Therefore, the business case requested by the Access and Interoperability Guideline is *effectively* for the requesting party, as the receiving party is unlikely to have a business case for opening up to competition.
- **Receiving party principle:** Article 51 of the Guideline highlights that the burden of adaptation broadly falls on the requesting party. Accordingly, the requesting party should pay for any additional costs related to setting up a link.

Following the entry into force of this part of the Code and the Guideline, there was a flurry of link requests, principally between infrastructures in major European markets. Some of these links have become operational (e.g. competitive clearing for the LSE). They work well, which proves that competition by means of links is possible and delivers immediate benefits. Other links are close to being finalised (e.g. competitive clearing for NASDAQ OMX's Nordic market, Chi-x, BATS Trading and Turquoise).

⁹ According to ESCB-CESR Recommendation 2 for CCPs on participation requirements and Recommendation 14 for SSS on access, a CCP or SSS can only deny access to its system on risk-related criteria, which should be explained in writing.

2.2.2. Remaining challenges

Notwithstanding these important advances and the significant market momentum demonstrated above, different barriers have made progress on link requests slow. There are inherent **commercial barriers**: while the new entrant is eager to gain market share, the incumbent is defensive, expecting to lose market share. Moreover, there are **technical/operational barriers**, as linking infrastructures can be difficult when business models, market standards, practices and technical communication languages between systems differ.

However, the most formidable obstacle has been issues related to **risk and regulation**. Market infrastructures are important for the financial system and are therefore heavily regulated at Member State level. As interoperability between CCPs has taken off, regulators have also started to grapple with the impact that interoperability involving many CCPs may have on the safety and soundness of infrastructures. Reaching a common response on these issues is difficult in view of regulatory differences. More specifically:

- **Risks related to links**: In line with ESCB-CESR Recommendation 11 for CCPs and 19 for securities settlement systems (SSSs) on risks in cross-system links, the Commission considers that links between infrastructures may give rise to risks but that these are manageable. Therefore links do not decrease safety provided that the risks are identified and addressed. The Commission considers that linked infrastructures should be transparent vis-à-vis regulators, other infrastructures with which they are linked and users about the risks they identify as a result of the link and how they address them. Moreover, the Commission takes note of ongoing work in the CCP area to (i) streamline interoperability agreements, e.g. by means of a convention as suggested by some, in order to increase transparency on risks and legal certainty, and (ii) harmonise communication standards.
- **Safety first**: The Code does not operate in isolation. Legislation takes precedence over self-regulation. Therefore, if there are regulatory concerns, these have to be addressed before links can become operable. The Commission acknowledges that some regulators have expressed concern as regards some of the ongoing interoperability requests involving CCPs. The Commission is in contact with these regulators, who value the increased choice and competition brought by interoperability and are working to ensure that interoperability continues to go hand in hand with safety. The Commission invites concerned infrastructures and their users to liaise proactively with these regulators to determine the exact nature of their concerns and come forward with suggestions for solutions in order to move forward in a timely manner. The Commission will continue to follow this matter very closely.
- **Regulatory differences**: In the absence of Community legislation, post-trade infrastructures are regulated at Member State level. If national legislation differ cross-border service provision becomes difficult. Differences also make it more difficult to reach a common position on how to address the risk concerns outlined above. CESR has concluded a mapping exercise¹⁰ that highlights that national regulatory arrangements indeed differ in how link requests are regulated, what the conditions are for cross-border service provision, the authorities involved, supervisory powers and

¹⁰ CESR (2009). *Preliminary technical advice on access & interoperability arrangements in the EU*, CESR/08-870.

how cross-border coordination is ensured. The practical experience of the link requests under the Code highlight that these barriers matter, as many requests have been slowed down due to these differences. The Commission's recent decision to propose legislation on CCP clearing by mid-2010 will address these issues and differences. This is further outlined in the next section.

Overall, the Commission and the MOG have devoted significant time to discern the nature of barriers and to engage with concerned parties in order to overcome them in ways that ensure an efficient, safe and sound post-trade system in Europe. The Commission has as a result gained significant practical experience about the exact type of obstacles preventing cross-border service provision, which has contributed to establishing the above-mentioned principles (e.g. on business case, no loss market share etc). This experience will be useful as the Commission prepares the legislative proposal on CCPs.

In sum, progress on link requests has been slower than initially expected. The Code has nevertheless given rise to a wealth of experience about the nature of obstacles to cross-border service provision and how they can be addressed.

2.3. Service unbundling and accounting separation

2.3.1. Achievements

Thanks to service unbundling, users are now formally able to buy separate trading, clearing and settlement services. Within the settlement layer, users can buy account provisioning services, clearing and settlement services, credit provision services, securities lending and borrowing services as well as collateral management services separately from each other.

As regards accounting separation, the Code has led to the creation of a rigorous process where concerned infrastructures prepare self-assessment reports and financial accounts separated along the lines of the Code and subject these to an external audit.¹¹ The self-assessment report, financial accounts and audit report are sent to their national regulators. Summaries of the reports and external audit are then made public. Infrastructures are then obliged to store the reports and accounts. This process facilitates the ex-post verification by relevant authorities in case suspicion of cross-subsidisation arises.

2.3.2. Remaining challenges

On service unbundling, there has been a limited take-up of the ability to purchase unbundled services from different providers. This is not necessarily surprising, as users may prefer to continue buying bundled services from the incumbent operator. However, limited price comparability and choice of infrastructure may also explain the lack of take-up. Therefore, progress on those two counts will further stimulate the effective take-up of unbundling.

On accounting separation, while the process is rigorous, limited information is made public in view of separate accounts being confidential. This makes it difficult for the Commission as well as users to evaluate the outcome. Moreover, there have been calls from infrastructures to reduce the costs of the external audit process. As the first external audit procedure has now been broadly completed, the Commission is launching a review

¹¹ FESE, EACH, ECSDA (2008). Terms of Reference for auditing compliance with service unbundling and accounting separation and assessing general compliance. August 2008.

of the procedure in light of first experiences with the view to ensure an effective and efficient focus on the core purpose of making transparent (i) the relation between revenues and costs of different services, and (ii) potential cross-subsidies between services.

3. GLOBAL ASSESSMENT AND FUTURE OUTLOOK

In view of the above, the Commission services believe that the Code has reached its objective of enhancing efficiency.

- The Code has increased transparency, as evidenced by the universal publication of fees as well as applicable discounts and rebates.
- The Code has contributed to an increase in competition, as evidenced by the rapid restructuring of Europe's post-trade landscape. The Code has acted as a catalyst and has allowed a much deeper understanding of the barriers to cross-border service provision, be they of operational, commercial, risk or regulatory kind.
- The Code has achieved significant results in the absence of a common legislative framework. It put the emphasis, and the projectors' lights, on action by the industry preventing protracted discussions, and the resulting inertia, during a lengthy legislative process. The Code also helped to reveal additional regulatory problems that need to be properly addressed. In that respect, the Code was a success; it achieved tangible results in a relatively short period of time and provided a wealth of practical experience.
- The Code has provided a voluntary framework and triggered a dialogue to address the barriers to cross-border service provision. The experience with the Code highlights that the Commission can perform a useful role not only as a legislator but also as an honest broker in the MOG forum in facilitating market entry and cross-border service provision.

Nevertheless, there are limits to what the Code can achieve as regards risk and regulatory barriers. Regulatory convergence by means of standards and recommendations is important. The Commission services therefore welcome the adoption of the ESCB-CESR recommendations. These provide important guidance to regulators and infrastructures alike on how to address risks.

The Commission services nevertheless believe that the issues related to risk and differences in regulation are of such a nature that they can only be addressed by legislation. As part of its actions to ensure the safety of derivatives markets, the Commission has decided to propose legislation on CCPs by mid-2010.¹² As many CCPs do not limit their services to derivatives, this legislation will cover all asset classes. It will accordingly address the issues related to risk and regulatory differences concerning CCPs highlighted by the Code.

The immediate focus on clearing is motivated by clearing being the part of the cash equity market where restructuring is most pronounced and where the need for a common approach to risk and regulation is the most immediate. Nevertheless, actions are foreseen

¹² European Commission (2009). Ensuring efficient, safe and sound derivatives markets: Future policy actions, COM(2009) 563.

in the settlement area as well, with the forthcoming Securities Law Directive (SLD) addressing legal barriers. Even so, there are areas not covered by the SLD and the Commission services will therefore continue to analyse settlement as well.

However, legislation is not a panacea. It is doubtful whether legislation is the most appropriate instrument to establish what technical standards or practices markets should follow. Therefore, self-regulation and legislation remain important complementary tools and the Code will continue to have a pivotal role to play. It facilitates the understanding of day-to-day market integration efforts and provides essential information to the Commission services in carrying out their duties. This experience gained is invaluable.

CONCLUSION

In 2006, the Commission decided that the time was not ripe for legislation and instead asked industry to commit to opening up their market in order to make Europe's post-trade sector more efficient. Three years down the line, this report assesses the effects of the Code.

The Commission services conclude that the Code together with MiFID has unleashed a significant restructuring of Europe's post-trade sector. Competition has increased, particularly in the clearing space, which is driving down prices and costs.

However, more remains to be done. Comparing prices between service providers have become easier, but remains challenging in view of underlying differences in business models. While competition has increased, there are obstacles to market entry and cross-border provision of services as issues related to risk and regulation need to be addressed. While services have been unbundled and accounts separated and audited, more information needs to be made public.

The Commission will propose legislation by mid-2010 on CCP clearing. This will address the issues related to risk, regulatory barriers to entry and cross-border service provision. Even so, the Code will continue to play an important role.