



**RESPONSE TO THE COMMUNICATION FROM THE COMMISSION  
TO THE COUNCIL AND THE EUROPEAN PARLIAMENT:**

**Clearing and Settlement in the European Union – The way forward  
COM(2004) 312**

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**Preamble**

virt-x welcomes the publication of the Communication from the Commission to the Council and the European Parliament entitled 'Clearing and Settlement in the European Union – the way forward' and we are pleased to be given the opportunity to comment on it. As essential components of a smoothly functioning securities market, clearing and settlement must enjoy effective competition and a level playing field, whereby free and fair access is provided to organisations which meet relevant criteria in respect of risk and standing.

This paper represents the views of virt-x in respect of the Communication and are expressed given the current high level of interest and focus on clearing and settlement with many statutory, regulatory and market initiatives being undertaken in this field.

**Background**

The historical perspective on clearing and settlement should not be forgotten in this debate since it has a direct bearing on the Commission's work in this field. In effect the mechanisms governing the clearing and settlement of bonds, equities and derivatives are distinctive. There has been a great deal of commentary to confirm that at the national level the clearing and settlement of bonds, equities and derivatives is largely efficient, appropriately regulated and meets the needs of the individual markets being served. The European concerns relate mainly to cross-border or cross-system processing, competition issues, rights of access and duplication of cost and investment and the risks arising thereof.

The emergence of the Euromarket (now the International Market operating under the market practices and rules of the International Securities Market Association - ISMA) and institutions such as Clearstream International, now wholly owned by Deutsche Boerse AG (DB AG) and Euroclear Bank (Euroclear), at the initiative of a broad range of international market players and with their support, was a response to the growing international nature of securities transactions and has been the main driver of the very substantial growth of cross-border trading in eurobonds and internationally traded domestic bonds during the last decade.

Institutions such as DB AG and Euroclear have not substituted an 'international' market for existing national markets. Instead, they have been and continue to be faced with the complex task of finding technical, contractual and legal solutions to allow national markets to 'link' with each other, while eliminating to the maximum extent possible risks that are associated with trading between entities that are established in different jurisdictions and in securities that are subject to widely different national laws and regulations. In essence the mechanism for trading bonds cross-border in Europe is highly liquid, and post-trade securities processing largely efficient. The main cost drivers in this environment lie in the need for indirect settlement links, combining the use of ICSDs, local agent banks and CSDs for local settlement in all EU countries.

In contrast, equities have never benefited from an efficient cross-border trading mechanism<sup>1</sup>. The ICSDs were unable to provide an effective cross-border equities solution because of the increased complexity of administering such instruments. The cross-border settlement of equities is currently carried out by a plethora of linkages, involving mainly agent and custodian banks; although this process is also consolidating. The products and services offered by these banks are tailor made to suit the needs of different segments of customers. In other words, where the plain vanilla cross-border settlement and depository services for bonds are centralised in the ICSDs, cross-border equities are non-standard and fragmented throughout Europe. This is due to

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<sup>1</sup> The introduction of SEAQ International in London in the mid-eighties served the limited purposes of market-makers trading in European and other blue chips but failed to provide an efficient settlement solution.

the lack of standards and non-harmonised European legal arrangements and other market practices issues identified in the Giovannini and various other reports. Further, the introduction of remote membership, anonymous trading and netting for equities has created the need for clearing and CCP services.

Similar arguments as for equities can be applied to cross-border derivatives.

### **Current situation**

virt-x has been established as an international trading platform which provides multiple clearing and settlement options, via links to ICSDs and CSDs and to 2 CCPs. Indeed virt-x responded to the requirements of its members by providing seamless multiple choice solutions while using efficient links to minimise the burden associated with national laws and legal arrangements, margin calls, etc. Given this, virt-x understands the issues and challenges facing the European clearing and settlement scene at this time.

The Commission has issued its Communication at a time when;

- Many market clearing and settlement initiatives are underway, e.g. Giovannini, CESR-ESCB and related initiatives, e.g. the Hague Convention,
- The EU has been enlarged to 25 countries, and a number of *Accession* countries are 'knocking at the door',
- Many EU countries are amending laws and regulations, establishing new CCPs or upgrading CSDs to respond to market practices changes or to comply with ECB and ESCB requirements in respect of monetary policy operations (RTGS and collateral mobility) required in the Eurozone and for TARGET.
- Comparisons are being drawn between European inefficiencies and US efficiencies in clearing and settlement, whereas the EU does not benefit from the governance arrangements in the US (where the powers of the prudential supervisor the Securities and Exchange Commission extend beyond their national boundaries) and operate under a largely harmonised legal, fiscal and tax regime.

Given this, many organisations are questioning the timing of even a 'Framework Directive' for clearing and settlement arrangements.

### **Complications**

- A large number of initiatives on clearing and settlement are running concurrently.
- The European governance arrangements (the respective roles of the EU Parliament, Council of Ministers, Commission, and CESR) and regulatory mechanisms (with many prudential supervisors and the ECB and ESCB) trying to implement measures to comply with European treaties and protocols, the Lamfalussy process and national supervisory and oversight arrangements do not form an ideal basis.
- The complexity of competition issues arising and the relative vagaries of roles and responsibilities between national competition and EU authorities as such govern clearing and settlement.
- The varying status and governance arrangements of institutions (including Enlargement and Accession countries), which provide clearing and settlement. For example, as private, government-owned, central bank controlled, or credit institution, as so-called vertically or horizontally integrated models or where such span a range of financial policies, for example, for-profit commercial, not-for-profit market owned and user governed, risk mutualisation, etc.
- The pace of change as such relates to the creation of new CCPs, repositioning of existing CSDs, consolidation initiatives, mergers and acquisitions and the implications for governance, access, perceptions of abuse, and risk.
- The lack of harmonisation within the EU as such relates to laws, fiscal policy, tax and market practices.

## Proposals

### General points

We consider that a Directive should seek to provide 'framework' measures only and as such should adopt a minimalist approach.

virt-x believes that the CESR-ESCB Standards (which were based on the CPSS-IOSCO Recommendations) provide sufficient detail for clearing and settlement functions and institutional activities but within this the subtleties of issues arising in CCP services may require particular attention. Governance arrangements should not be included in a Framework Directive but should be part of 'best practice rules' and self-regulatory measures.

The opportunity for segregating functions (operational risk based versus added-value) normally referred to as '**structural unbundling**<sup>2</sup>' within CSDs has been largely lost and attempts to recover this by favouring '**functional unbundling**<sup>1</sup>' will do more harm than good. virt-x would prefer such functions to be subject to 'best practice rules' and self-regulatory measures. Further, virt-x considers that reference to or comparison between infrastructure and intermediary is unhelpful but 'Essential Facility'<sup>3</sup> in the context of clearing and settlement and CCP arrangements will have significance for some time to come.

virt-x suggests that the Commission considers making explicit the process of sanctions bearing in mind the roles of CESR in terms of the Implementation measures and the national prudential supervisors under their respective laws as well as the Commission's own powers at the EU level.

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2 Separation of the various components of production, distribution and service in order to introduce greater elements of competition to these segments of an industry. 'Functional unbundling' requires monopolistic utilities to provide access to (part of) their distribution or service network, in exchange for an access fee. 'Structural unbundling' makes complete vertical separation necessary and obliges monopolistic utilities to divest their production, their distribution or their service assets.

3 An Essential Facility is defined by the Commission as a facility or infrastructure which is necessary for reaching customers and/or enabling competitors to carry on their business. A facility is essential if its duplication is impossible or extremely difficult due to physical, geographical, legal or economic constraints. It is also important to note that the definition of Essential Facility can be based on the level of impact of failure in respect of systemic risk, abuse of position, reputational risk, etc. Denying access to an essential facility may be considered an abuse of a dominant position by the entity controlling it, in particular where it prevents competition in a downstream market.

## **Particular points on the Communication**

1. virt-x welcomes the main thrust of the Commission Objectives (page 8 of the Communication) and supports measures aiming at the liberalisation and integration of existing clearing and settlement systems through the introduction of comprehensive access rights at all levels and the removal of existing barriers to cross-border clearing and settlement, the continued application of competition policy and the adoption of a common regulatory framework. That said, the implementation of appropriate governance arrangements for clearing and settlement should not be covered within a Framework Directive.
2. It is understood that the term CSD and the functions therein are very different and in an Enlargement, Accession and consolidation scenario give rise to particular concerns in respect of the 'Single Market' as well as potential public policy and risk issues. Within this, page 6 of the Communication describes the view that CSDs should limit their activities to those giving rise solely to operational risk and which require functional separation from so-called value-added services. ***virt-x believes that the clearing and settlement process is already in 'deep change' given EU consolidation, enlargement and accession and that such a functional separation would be disruptive and potentially costly. virt-x would propose that such functional separation is not a subject for a Framework Directive but that a more effective alternative would be to define European 'Best practice rules' and subject to 'Self-regulation', bearing in mind that this would still be subject to supervision by CESR-ESCB Standards and via the powers devolved to respective prudential supervisors and competition authorities.***
3. The Commission refer to a requirement to study thoroughly the US example of a unified clearing and settlement and custody framework (page 6 of the Communication). ***virt-x points out that such a model was created by regulatory intervention (and the regulator had the necessary authority) when it appeared that the market themselves could not decide on a unified model. Further, the unified model in the***

*US operates under a largely harmonised legal, fiscal and regulatory environment and, last but not least, the powers of the Securities and Exchange Commission extend beyond their national boundaries. The EU on the other hand has decided that the consolidation of clearing and settlement and central counterparty services should be left to 'market forces', the EU has been enlarged to include 10 new countries with a number of Accession Countries in process, the legal, fiscal and regulatory environment is far from harmonised, and the European Treaties and Protocols do not confer powers beyond that of the EU to any regulatory body (to a single prudential supervisor or combination thereof or to the European Central Bank). For these reasons, virt-x believes that the pursuit of an EU model would be a more pragmatic approach. virt-x does, however, believe that the US unified model recognises the unique role that the DTCC plays in the US market and is more comparable with the term Essential Facility (see footnote on page 5) and therefore distinct from an intermediary credit institution status.*

4. On the adoption of measures intended to liberalise access to establish a common regulatory framework ..... (page 10 of the Communication), *virt-x supports the need for common definitions in respect of the clearing and settlement function and has already made comments in respect of segregation (point 2 above). virt-x does, however, believe there is a need to distinguish between Essential Facility (see footnote on page 5), rather than infrastructure, and other intermediary processes, e.g. credit institutions since such may form the basis for competition issues arising, e.g. a CSD (possibly owned by a stock exchange) which may benefit from a 'monopoly effect', e.g. via exclusive arrangements, special legal status or market position.*
5. Once all required measures have been adopted, consolidation among Securities Settlement Systems and Central Counterparties is expected to accelerate (page 11 of the Communication). *virt-x agrees that such harmonised measures tend to lead to 'system' consolidation but would also point out that innovation and diversification are also*

***common reactions; this may further add to the complexity with regard to a Framework Directive.***

6. The Commission considers that it will need to play a major role in providing the necessary political impetus ..... (page 11 of the Communication). ***virt-x agrees with this statement and its intention to set up an Advisory and Monitoring Group, and while it understands the role a Framework Directive may play in supporting the removal of the barriers identified within the Giovannini Group, virt-x points to the need for greater involvement of ECOFIN when it comes to the harmonisation of legal, fiscal and tax issues. In particular, virt-x welcomes the involvement of the Commission and national competition authorities in respect of anticompetitive market practices and monopoly positions arising as a result of further consolidation.***
7. There are several ways to deal with the issue of supply of Banking services by Securities Settlement Systems under monopoly conditions (page 22 of the Communication). .... ***virt-x accepts that there are alternative ways to handle such issues but would like to point out that settlement in both central bank and commercial bank money must be possible. Further, participants in one EU country require to have free access to and be able to administer an account in the national central bank of another EU country; this issue may well be magnified when it comes to EU countries which have 'pre-in', Enlargement or Accession status.***
8. With regard to Competition policy (page 28 of the Communication), virt-x welcomes the implementation of Council Regulation 1/2003 and recognition of the need for increased cooperation between national competition authorities and the Commission. ***virt-x believes that 'merger thresholds' of Council Regulation 4064/89 among other measures lack precision in the field of mergers relating to consolidation or cooperation in clearing and settlement and central counterparty services and that any major initiatives involving an SSS, (I)CSD or CCP should be regarded as having automatically a 'European***

***dimension'. By way of example, and while virt-x implies no criticism, if the Herfindahl-Hirschmann Index (HHI)<sup>4</sup> is applied to the Euroclear and DB AG consolidation initiatives as such impact clearing and settlement, which concentrate the interests of a number of national CSDs and exclusive outsourcing arrangements with ICSD capabilities, the HHI is very high at the EU level. Further, the Commission would be wise to consider any Spillover<sup>5</sup> effects with regard to current and future consolidation initiatives, particularly with regard to Enlargement and Accession countries. virt-x believes that the Commission is right to focus on competition rules in respect of the supply of services and non-discriminatory access and further, and agrees that the Commission is not a price regulator. However, there is potential for, or perception of, issues arising from a provider of clearing and settlement functions which may form, for the time being at least, exclusive arrangements or, which could be deemed to form part of, an Essential Facility (see footnote on page 5), where that provider could apply pricing arrangements which generate excessive margins to effectively cross-subsidise services subject to commercial competitive pressures (e.g. within a vertically integrated market model).***

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4 Specific measurement of market concentration, that is, of the extent to which a small number of firms account for a large proportion of output.

The HHI is used as one possible indicator of market power or competition among firms. It measures market concentration by adding the squares of the market shares of all firms in the industry. Where, for example, in a market five companies each have a market share of 20 %, the HHI is  $400 + 400 + 400 + 400 + 400 = 2\,000$ . The higher the HHI for a specific market, the more output is concentrated within a small number of firms. In general terms, with an HHI below 1000, the market concentration can be characterised as low, between 1000 and 1800 as moderate and above 1800 as high.

5 Side effects of an agreement or a merger between two or several firms, which affect competition between them in another relevant market than the one covered by the agreement or the merger in question. Spillover effects are referred to in Article 2(4) of the merger regulation, which concerns the creation of a joint venture that has as its object or effect the coordination of the competitive behaviour of undertakings that remain independent. In that case, the Commission shall appraise this coordination also taking into account whether two or more parent companies retain, to a significant extent, activities in a market which is downstream or upstream from that of the joint venture or in a neighbouring market closely related to this market.

9. The Communication makes reference to non-standard descriptions, e.g. investor-CCP (page 5 footnote 3), which require clear definition. ***virt-x proposes that non-standard descriptions should be replaced or clearly defined to avoid confusion.***

virt-x would be pleased to provide further explanation or support as required.

30 July 2004

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