

Breaking with the Tradition of Market Fragmentation

a report by

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Yannic Weber is Managing Director and Deputy Head of Euroclear's Commercial Division, and a member of the Euroclear Bank Management Team. Mr Weber joined the Commercial Division in 1994, and was promoted to the position of Managing Director and Head of Sales & Marketing in 1996. From 1991 until 1994, he held various positions in the London office of JP Morgan Securities Ltd, including Product Development Manager for the Exchange Traded Products Group. In 1987, he was promoted to head Euroclear's New Issues and Custody Department, having joined the Euroclear Operations Centre in 1983 to work in the custody area. Earlier in his career, Mr Weber served as a Tax Advisor for Touche Ross & Co., having trained as a lawyer specialising in tax affairs.

In spite of everybody's best intentions, Europe's capital markets remain resolutely disunited. The introduction of the euro and an increasingly borderless Europe dictate that a less fragmented environment for the trading, clearing and settlement of securities transactions is now an urgent imperative.

The recent formation of Euronext, the unified stock exchange created by the merger of the Paris, Amsterdam, and Brussels bourses, is a good example of consolidation in the area of securities trading. The Irish Stock Exchange's adoption of Deutsche Börse AG's Xetra platform and the National Association of Securities Dealers Automated Quotation's (NASDAQ's) impending takeover of the European Association of Securities Dealers Automated Quotation (EASDAQ) are further proof of this rapid consolidation.

Insofar as clearing is concerned, there have been some moves – vocally supported by the market – to consolidate the operations of Europe's three main clearing houses – Clearnet (France), The London Clearing House Ltd (the UK) and Eurex (Germany). These have yet to result in any actual rationalisation, but the portents are good.

On the settlement side, Euroclear has been involved in the consolidation of most, if not all, of the recent initiatives to consolidate Europe's securities settlement systems. In 2000, plans to fuse the central securities depositories (CSDs) of France, Belgium, the Netherlands and Ireland with Euroclear's own cross-border platform were announced, thereby creating a single group stretching across four national boundaries.

Clearly, these are times to break with tradition – at all levels. Nonetheless, some traditions are proving difficult to leave behind. One of these is the system of exclusive links that exists between local stock exchanges and local settlement systems in many European marketplaces. The perpetuation of these privileged relationships (or vertical 'silos' as they are also known) is prohibiting competition and the creation of a truly integrated and liquid pan-European equities market. The obstacles hampering progress in this area are linked primarily to infrastructure and regulatory issues.

Hampering Efficiency and Competition

The disproportionate number of stock exchanges, central counterparties (i.e. clearing houses) and settlement systems that exist in Europe today is one of the major obstacles to the development of a more efficient European capital market. This fragmented landscape results in exorbitant costs, in various forms, for the market, thereby making equity – and bond – transactions far more expensive than in other capital markets, such as the US.

It is estimated that the total cost of operating the settlement systems of the EU's 15 markets exceeds R 1.2 billion per annum, compared with just €0.5 billion in the US. In addition, users' own back-office costs are kept unjustifiably high as a result of the investments they are required to make in order to be able to interface with the multitude of systems in existence. For example, automating an interface with just one settlement system can cost up to €1 million in up-front investment for a single user, and operating a systems interface requires operations personnel familiar with the intricacies of that market and that system, ergo additional costs.

This lack of consolidation also means that there is what can only be described as a sub-optimal use of collateral, as a direct result of investor holdings being dispersed among a large number of service providers. In the current environment, securities collateral is less mobile than cash, thereby reducing opportunities for secured financing.

A requirement for attracting more pan-European equity investment is the capability to move investments quickly from one industrial sector to another. The development of sectoral trading has been obstructed by, among other things, local market infrastructures, which tend to integrate trading, clearing and settlement services in the vertical manner described above. These structures hamper the introduction of competitive post-trade services for equities listed on competing exchanges, ultimately preventing the development of pan-European markets.

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An important point is that the vertical integration in and of itself is not necessarily harmful. In fact, by ensuring efficient flows from trading to netting to settlement, it can reduce both costs and risks. In an era when domestic financial institutions dealt almost exclusively in domestic securities, it was certainly the most appropriate solution. Such an era, however, is now wedged firmly in the past.

The primary threat to a unified capital market in Europe today comes from what is known as exclusive vertical integration, where a trading platform or central counterparty forces its clients to use a particular settlement platform. This prevents users from choosing other settlement platforms, even though these may be more secure, efficient and/or less expensive. As financial institutions now trade and invest on a pan-European basis, there is little logic in forcing them to continue interfacing with a multitude of exclusive silos.

Time for Regulatory Relief

Notwithstanding the plethora of EU legislation enacted in recent years to foster a single European market, significant market and regulatory obstacles continue to exist in several European countries that have the effect of slowing down the development of a unified pan-European securities market.

In a number of European markets, including the UK and Germany, stock exchange regulations require that trades in listed securities settle on the books of the national CSD. In other markets, listings on locally regulated stock exchanges require registration in a local register. All such regulations imply, in practice, that trades executed on a local stock exchange must settle in the local CSD, thereby preventing competition between settlement providers for on-exchange transactions. In addition, these regulations preclude users from centralising their settlement activity in fewer systems, which merely perpetuates the high infrastructure costs already mentioned.

Moreover, market-makers in many European government bonds have to comply with a plethora of local market regulations requirements including, for example, the setting up of local securities operations and the settlement of primary market transactions in the local CSD. These rules also prevent market-makers who are active in several countries from benefiting from the cost savings derived by settling trades in fewer settlement systems.

In addition to this, several European countries still require the involvement of a local credit institution to ensure the application of withholding tax on outbound dividend and interest payments, and/or to offer withholding tax relief at source or through refund procedures.

This represents yet another layer in the custody chain and increases the cost of cross-border holdings. The problem is exacerbated by the fact that withholding tax relief procedures vary substantially from country to country, resulting in great complexity and administrative costs for the market.

The Solutions

As a prerequisite to the development of a competitive and cost-efficient, pan-European securities settlement infrastructure, it is imperative that existing regulatory barriers are removed, with a total moratorium being placed on the introduction of additional such obstacles. First and foremost, this involves the removal of national regulations that today prevent issuers from depositing and distributing securities in the CSD of their choice. Moreover, clients who choose to trade on a given stock exchange should be allowed to settle their equity transactions in the settlement system of their choice, rather than be forced to use the national CSD of the stock exchange on which they are trading. Otherwise, the European financial market infrastructure will continue to develop with trading and settlement silos, which will only create the worst of two worlds – duplication of expensive investments without the benefits of competition.

CSDs should also be encouraged to offer their services to all clients on equal terms and at the same costs. Indeed, there exist in most Member States significant de facto obstacles of access to local CSDs, which, in turn, prevent foreign and international CSDs from competing on fair and equal terms. This is a particularly important element in cross-border securities settlement, since national and international CSDs are not only competitors, but also suppliers of services to one another. In short, practices that enable a national CSD to offer a less attractive and/or more costly service to competing national and international CSDs than to its other clients should be discontinued immediately. In addition, issuers seeking to list equities on a local exchange are obliged by certain local exchanges and/or local CSDs to deposit, for distribution, the entire issue in the local CSD. Such a practice prevents issuers from depositing in a national or international CSD of their choice, regardless of the local exchange on which the issue is listed. The effect of these obstacles is to artificially preserve the position of local CSDs. For this reason, if for no other, such barriers must be removed.

The European securities settlement industry is in the midst of a significant process of consolidation. Future service providers will be those that are best able to offer a competitive, efficient and cost-effective solution that is genuinely attractive to market users. This process must be directed not by the upstream stock exchanges, but by the users themselves. The competitiveness of Europe's capital markets depends on it. ■