Re: call for evidence on a formal request for technical advice on identification of regulatory arrangements for post-trading infrastructures *(Ref.: CESR/08-643)*

Dear Sir or Madam:

This is the response of Equinox Consulting to the consultation on the above statement. Equinox Consulting is a consulting firm composed of 150 consultants in several European countries. Our clientele consists mainly of financial institutions including both commercial banks and financial infrastructure providers (A company prospectus is enclosed in the appendix). We are writing to share with you our experiences with a number of market actors[1] and our internal reflections regarding the challenges that the European Interoperability and Access guideline and MiFID have been facing in these past months.

We believe that while the trading and settlement layers are today able to provide cross-border services, the clearing layer is where interoperability is encountering major difficulties. Trading platforms can compete courtesy of MiFID, and CSDs interconnect base on pre-existing agreements between regarding cross-border settlement. Clearing houses, however, lack both regulatory guidance and commercial precedents, meaning that CCPs are the entities faced with the greatest degree of barriers in the implementation of the Code of Conduct.

Over and above any attempts by various parties to erect protectionist barriers to entry, a lack of regulatory homogeneity limits the possibilities for CCPs wishing to provide services outside of their home states. This uneven regulatory landscape is in part due the different ways of regulating foreign and domestic clearing services in different countries. It is further exacerbated by different technical or legal requirements which require CCPs to envisage massive changes to existing systems, and capitalistic structures which discourage or inhibit competition.

Challenge 1: Regulatory model differences

The Financial Services Authority (FSA) in the United Kingdom has created a legal and regulatory framework for the provision of clearing services for UK markets by a non-UK entity. The FSA requires that the overseas clearing house[2]:

- Afford "equivalent" protection to investors
- Have procedures be in place to deal with the case where the clearing house were not to fulfil its obligations
- Be able and willing to cooperate with the FSA through information sharing or other means
- That cooperation agreements are in place between the FSA and the home supervisory authority

This concept, the *Recognised Overseas Clearing House* or ROCH concept, permits the FSA to allow competitive entry into the UK market without necessarily directly supervising the entity (beyond the minimums outlined in the FSMA 2000.) The ROCH concept does not appear to exist in other markets on the continent.

[1] *Including Infrastructures (Clearing houses, MTFs, historical markets) as well as market participants (trading, clearing and settlement participants)*

[2] *Taken from the Financial Services and Markets Act 2000, subsection 292. The text presented is a summary and not a direct quote.*

Given the lack of recognition for foreign clearing houses, agreement-specific structures and memorandums of understanding are used for the provision of cross-border clearing services, resorting at times to direct regulation by multiple regulators. This is the case, for example, of LCH.Clearnet SA for the Belgian, Dutch and Portuguese markets.

Other pan-European clearing houses, however, follow a regulatory model closer to that used for the provision of cross-border services using the "banking passport" principle. This is the case of EMCF N.V. which is "home regulated" as a CCP in the Netherlands, however provides clearing services in the UK on securities which are settled in a number of different securities depositories across Europe. EuroCCP will use a similar model, but under the supervision of the FSA.

All of these examples of international clearing house recognition (attribution of a formal status, ad-hoc agreements, or a global "passporting" model) could produce an environment which would facilitate cross-border provision of clearing services. However we believe that coexistence of these different models does not help CCPs attempting to connect to one or more other markets.

The differences in terms of recognition mechanisms add to the differences between regulatory models at a much higher level. In the United Kingdom, the FSA is the single authority which regulates clearing services.[3] In France, as clearing houses are required to have banking licenses, they are regulated by the CECEI, CB, AMF and BdF. In Germany, the ministry of finance via the BAFIN empowers the exchange councils (Börsenrats) which is closer to a "user-regulated" model. With such drastically different environments, it comes as no surprise that clearing houses who attempt to operate abroad face significant difficulty in apprehending the nature of regulation in other countries. Far from trying to harmonise the models, we believe that mechanisms must exist which enable competing infrastructure providers to overcome regulatory model differences while continuing to be effectively supervised.

In the case of investment service provision, the MiFID introduced the European-level "banking passport" principle which opened national markets to wider competition. This passporting principle permitted market actors to be "home regulated" while operating in another state. Market infrastructures, however, cannot be considered on the same playing field as they introduce elements of systemic risk. It is therefore understandable that "host regulators" wish to follow their activity more closely, in particular in relation to matters such as membership requirements, risk management, default management, and global settlement efficiency.

Consequently, we believe that a harmonised recognition mechanism (such as an extension of the ROCH principle) is required at a European level. This is the best way to ensure a level regulatory playing field for actors who aim to provide cross-border infrastructure services.

Challenge 2: Technical and Legal Standards

Beyond the debate on the regulation of cross-border clearing or national regulatory models, we believe that the lack of a uniform set of basic functionalities across Europe is also a cause of barriers to entry.

It is perfectly understandable that markets will have specificities linked to their history and their competitive positioning. For example, the settlement offset varies by market (2 days or 3 days) and fail and buy-in procedures may not be exactly identical. These could be considered "market

[3] *For all countries, the primary regulators are referred to while there may be other direct or indirect regulations by higher authorities (i.e. secretary of state)*

practices" and therefore entering CCPs would either have to adopt these practices or propose alternatives on the market, subject to technical/conceptual compatibility. Other practices, however, are the result of specific national frameworks such as the German deposit law which requires failed net settlement instructions to be "traced" back to the individual trades which constituted the instructions (GDM).

In our experience, we have seen that by-and-large, market practices do not constitute barriers to entry for CCPs. On the other hand, select practices (GDM, for example) require such massive customisation to systems that incoming competing clearing houses are faced with daunting investments.

Drawing the line between what is required from a legal and/or regulatory perspective and what is a subject for competition is difficult. All regulators would agree that T+2 and T+3 settlement delays cannot coexist on the same market; however GDM is only required by select regulators in Europe.

As these debates oppose national regulators and post-trade conceptual models, we believe that a wider European forum needs to be created to agree on a three-level framework for cross-border service provision.

1. European Standards for Clearing Services
2. National Standards for Clearing Services
3. Non-Standardised Matters (matters for competition)

A three-level framework enables separation between elements required for continued market efficiency, and follows the successful models used by both MiFID and (on a global scale) Basel II. The separation between accepted European-level minimum standards, national standards (which would take into account "market practices") and non-standardised matters would largely facilitate competitive entry. This also presupposes that these standards be explicitly described for incoming competitors so that they can distinguish mandatory and optional practices.

This is clearly an experts' debate, which could take place (and does on select topics) in circles such as EACH, ECSDA or FESE, similarly to those debates which take place in the IATA or ITU on minimum international service levels. European and national endorsement of the conclusions, however, is required in order to ensure that these basic standards are adhered-to. After such endorsement, any infringement by national regulators or by trading, clearing or settlement infrastructures can be resolved through commercial litigation, competition law or in regulatory circles at the appropriate level. Discussions will also permit the identification of specificities in select markets which could either be extended at the European level to promote market security, or removed if they constitute excessive barriers to entry.

Challenge 3: Trading, Clearing and Settlement separation – transparency for infrastructures

In the case of post-trade infrastructures, there are dramatic economies of scale both through horizontal and vertical integration. Horizontally, network economics demonstrate that a larger network increases the global welfare in the system. This is inherently true even in the name of CCPs, as fewer "central" counterparties enable true anonymous trading and reduce the need for capital to be scattered in deposits in multiple locations. Vertically, the economics are both in technical (IT) terms simply because of economies of scale – but also in the efficiency benefits that can be gained by bringing operational entities across the three layers closer together.

Advantages to vertical integration, however, may constitute barriers to the Code of Conduct which introduces competition at trading, clearing, and settlement layers. Competition logic suggests that in order for competing CCPs to enter a market, they must have access to (*a minima)* the same service level that is available to the existing CCPs from other critical infrastructure elements – namely the trading platform and CSD. In the case where all the layers belong to the same group, costs and revenues can be placed at the point in the value chain which enables "group" profits to be protected. Yet just as in the telecommunications or transportation markets certain infrastructure elements are required for commercial success (e.g. customised access to national CSDs), holders of these resources possess monopoly power that they can use to keep competitors at bay. It should be noted that in these other industries, access to such critical resources is either controlled directly by regulatory authorities or closely monitored to ensure that no particular party receives preferential treatment.

The Code of Conduct presented interoperability as the second target in its roadmap, yet we firmly believe that the third objective is far more important. **The accounting, legal and operational separation between trading, clearing and settlement is a necessary precursor to effective interoperability**. This also includes regulatory supervision of each entity individually regarding operational standards, capital adequacy, and competitive practices. Concretely, we believe that pricing and detailed description of services provided between layers (e.g. settlement services provided to CCPs) should be fully available to all parties entering a market on request.

Conclusion

We acknowledge that the decision making framework in a European context is not simple, with national and European-level entities often displaying irreconcilable, but equally valid, points of view. We suggest, however, that the European Commission provide a minimum of legal framework to permit interoperability to come to fruition. While we do not suppose to have the precise solution, we believe a legal framework is required to address:

- The recognition of cross-border clearing service providers through a harmonised ROCH-like mechanism
- The creation of a framework to identify subjects for European and national-level standardisation and subjects that will remain in the competitive domain
- The further separation of trading, clearing, and settlement layers and transparency for services provided between parties, regardless of the degree of vertical or horizontal integration

We trust that by sharing our perspectives with you, we have provided some material for debate and further investigation. We remain at your disposal for any questions you may have.

Sincerely,

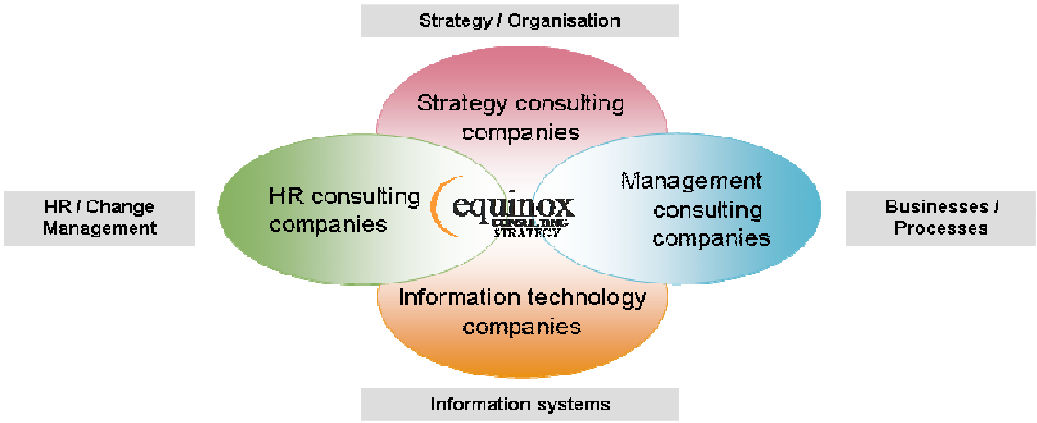
Jean de Castries,
Partner at Equinox Consulting

APPENDIX: Presentation of Equinox Consulting

Positioning

Equinox Consulting is an independent management consultancy dedicated to financial services.
Launch in January 2004:

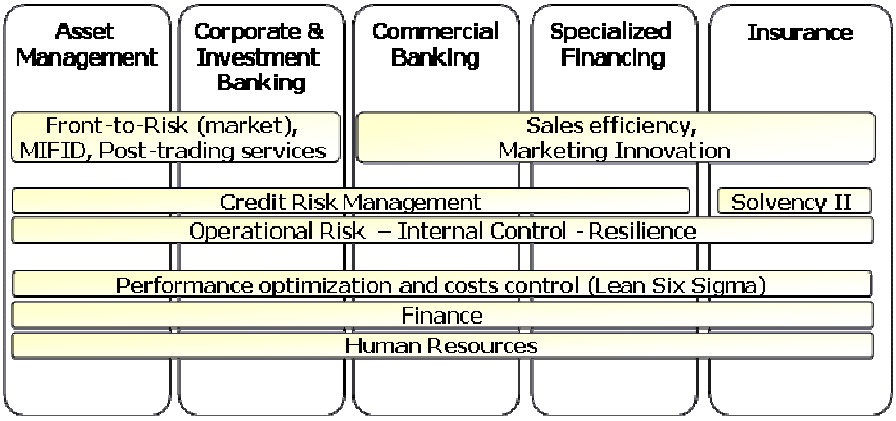
- Start up of Equinox Strategy in April 2005
- Diversification in the telco industry in 2007
- Launch of Equinox Consulting España in May 2007
- Diversification in the international retail expansion business in 2008



Service offering

Equinox Consulting offering is focused on financial services and follows 3 goals:

- Revenue growth
- Risk Management
- Organisations and performance optimisation, for both support and revenue creation functions



For any additional information please contact:

Jean de Castries
Partner
jdecastries@equinox-strategy.com
+33 6 29 96 57 01

Gaspard Bonin
Manager
gbonin@equinox-consulting.com
+33 6 27 31 07 76

Antoine Pertriaux
Manager
apertriaux@equinox-consulting.com
+33 6 09 66 18 81

… Or visit or website: www.equinox-consulting.com