



Clearing and Settlement: Key Issues in the light of MiFID

This White Paper is part of a series of Equiduct Trading sponsored research papers that aim to increase awareness of the impact of MiFID and to assist the financial community in the practical implementation of MiFID.

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About Equiduct Trading

Equiduct Trading will offer a MiFID compliant, integrated pan-European single point of connectivity for trading services through the Regulated Market operated by Börse Berlin.

Equiduct Trading will offer a range of services to enable financial institutions to meet their statutory commitments to provide best execution and transparency to their clients for all equity instruments listed on the European Economic Area (EEA) regulated markets (RM), in a single point of contact and cost effective manner. Equiduct Trading will also eliminate the need for financial institutions to become 'Systematic Internalisers' (SI).

Equiduct Trading's "Best Execution" and trade reporting services drastically reduce the cost and time required for participant firms to achieve MiFID compliance in these areas, while simultaneously enabling MiFID related revenue streams and market penetration. Additionally, Equiduct Trading offers very low cost per transaction relative to other exchanges as well as unique settlement flexibility and guaranteed execution in a protected environment. Retail investors will benefit from Equiduct Trading's transparent environment and will receive the guaranteed best price and very low transaction cost.

**This White Paper does not constitute legal advice.
Specific legal advice should be taken before acting on any of the topics covered.**

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1 Introduction

The previous white papers in this sponsored series have been written by independent market experts and when this paper was originally discussed Willy Van Stappen was indeed both a market expert and independent of Equiduct. Since then, Willy has left his position at LCH.Clearnet SA and joined Equiduct Systems as its Chief Operating Officer, where he will have a chance to put his vision on clearing and settlement in a post-MiFID world into practice.

MiFID aims to foster competition in securities trading by abolishing the concentration rule and by introducing a harmonised regulatory framework for the 3 different types of execution venues: Regulated Markets (RM), Multilateral Trading Facilities (MTF) and Systematic Internalisers (SI). As such, MiFID focuses primarily on trade execution services and much less on post-trade services, such as clearing, settlement and custody, which take up a large part of overall trading costs. The European Commission is well aware - and numerous reports have been dedicated to this issue - that there is currently no cross-border competitive level playing field for these post-trade services, but it has up until now favoured industry self regulation (through a voluntary Code of Conduct) rather than hard law to remedy the numerous market failures in this area. MiFID in its articles 35 and 46 does however state that investment firms should be able to freely choose the most appropriate clearing and settlement provider, independent of its nationality.

Investment firms are thus expected to have more freedom to select the most appropriate clearing and settlement location, whether in their capacity as intermediary or as an execution venue (Systematic Internaliser or SI). Likewise, newly created RM or MTF will have to decide which post-trade automated or non-automated access they grant to their market participants. Existing RM and MTF could face pressure from their participants to increase the number of post-trade options currently available to them.

This White Paper intends to assist investment firms in the decision making process as to what constitutes the most appropriate and efficient clearing and settlement model for their business.

It is clear that a significant proportion of the clearing and settlement requirements for Trading Member Firms (TMF) and their Clearing Member Firms (CMF), Regulated Markets (RM) and Multilateral Trading Facilities (MTF) are fundamentally the same. Each requires Liquidity, Connectivity, a Standard Settlement Model, Minimal Intermediaries Processing, Fungibility of Stock (for risk and position keeping) and Fees as low as possible.

This White Paper shows how the needs of each are interlinked and why it is important that the RM and MTF use the same criteria as their market participants when setting their own clearing and settlement policy. The analysis of this White Paper is based entirely on the characteristics and realities of the *existing* fragmented European clearing and settlement environment. The recommendations in this White Paper can therefore be implemented immediately and are not dependent on how this environment could or should evolve over the coming years.

2 Central Counterparty Available

2.1 Assumptions

In this paragraph we assume that:

- (i) the TMF executes transactions for its clients in ISINs (stocks) that on their home market are routed to a CCP for clearing and subsequent settlement;
- (ii) the TMF uses a Clearing Member Firm for post-trade services, rather than having a direct membership with the CCP. This being said, the reasoning and conclusion of this chapter would be the same if the TMF would have a direct membership of the CCP.

When settlement on the home market has an obligatory CCP phase as part of the value chain, the TMF executing transactions through an RM or MTF will expect that the CMF representing their interests would seek a post trade environment at least as cheap and at least as uncomplicated as the one already participated in when trading with the home exchange. The elements a trading firm would expect to be looked at are CCP membership, the regulatory environment, liquidity, fees, costs related to settlement (e.g. realignments) and risk management.

2.2 Membership

The CMF will seek, on behalf of the TMF they represent, to minimise effort and cost for transactions including any requirements to post margins. Therefore, a CMF will seek membership of a Central Counterparty (CCP) only when strictly needed i.e. when there is an organised cash clearing process for the home market that is obligatory to participate in.

2.3 Regulatory

A CMF will prefer membership of a CCP in a jurisdiction he is familiar with and a regulatory environment he is already part of.

2.4 Liquidity

A CMF will prefer the CCP that already provides clearing services for a given security. The greater the settlement volume the CCP concentrates for a given ISIN the more effectively the CCP will be able to organise position risk offsetting to the individual and thus the better the liquidity.

2.5 Fees

For both Professional and Retail clients MiFID Best Execution requires a number of factors to contribute toward the target of achieving the best possible result for the client. This is particularly important for Retail clients who are said to have achieved best execution when they have received the best price inclusive of expenses - this can be thought of as the "best economic value":

Level 2 Directive, Article 44

*"3. Where an investment firm executes an order on behalf of a retail client, the best possible result shall be determined in terms of the total consideration, representing the price of the financial instrument and the costs related to execution, which shall include all expenses incurred by the client which are directly related to the execution of the order, **including***

execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.”

A client will ask his TMF to prove that C&S is organised such that this best economic value is provided. Therefore the TMF will prefer that C&S takes place where fees are transparent. Ideally, pre-trade transaction cost analysis (TCA) for the TMF would be greatly facilitated if the C&S fee relating to a transaction in a particular ISIN does not vary as a function of which MTF or RM delivers the executed trade flow to the CCP . The TMF will prefer a situation where it is easy to prove that the fee is only a function of the service delivered by the CCP and that the fee for a “like for like” service is the same independently of the MTF or RM that provides the trade execution and matching services.

Having the C&S organised at the existing infrastructures rather than at newcomers increases the cost transparency and facilitates the discussions between TMF and their clients considerably.

2.6 Realignments

A CMF will prefer the CCP that links directly for settlement with the issuer CSD, usually the home country CSD for the securities listed on the local regulated market (i.e. CREST for London Stock Exchange, Euroclear France for the Euronext French market segment, etc.)

A CCP that settles securities in a CSD different from the issuer CSD will, in general, be more complex and costly to operate due to different settlement windows, realignments of liquidity and complexity of reconciliation issues, all of which are likely lead to increased costs and therefore not provide best economic value (see above).

2.7 Risk Management

A CMF will prefer to use the services of the CCP that can offer a portfolio approach in its risk management, independently of who are the execution venues that are used for matching the trade. The CMF will expect the CCP to group ISINs rather on the basis of their risk characteristics than on the basis of the trading venue they are traded on. Only such a CCP will be able to take advantage of the fungibility of the transactions for a given ISIN code coming from different trading venues

The CCP with direct feeds from multiple trading venues, trading in common ISIN codes, will be in a better position to capture the business of TMFs that want to spread their execution venue risk and to allow CMFs to make better use of its existing services.

3 No Central Counterparty Available

3.1 Assumptions

In this paragraph we assume that:

- (i) the TMF executes transactions for his clients in ISIN (stocks) that on their home market are not routed to a CCP for clearing and subsequent settlement;
- (ii) the TMF uses a custodian as settlement agent for the settlement of transactions in these ISINs rather than having a direct membership of the applicable CSD. This being said, the reasoning and conclusion of this chapter would be the same if the TMF would have a direct membership of the CSD.

When settlement on the home market has no obligatory CCP phase as part of the value chain, the TMF executing transactions in these same ISINs through a RM or MTF will expect that the Custodian representing him as Settlement Agent (SA) in the settlement process will seek the cheapest and least different solution for the post trade environment when compared to the one already in place in the home market. The elements a trading firm would expect to be looked at are CSD membership, the Regulatory environment, liquidity, fees, costs related to settlement (e.g. realignments) and risk management.

3.2 CSD Membership

A TMF with no direct membership of the issuer CSD will prefer to partner with the Custodian that already has either a direct link with the issuer CSDs that organise settlement for the different ISIN codes traded or an indirect one through a local (sub)-Custodian. The more CSD links the Custodian has, the more important the economies of scale the TMF will benefit from.

3.3 Regulatory

In order to reduce time, effort and cost and to ease the regulatory conditions, the TMF with no direct issuer CSD membership will want a single centralised legal relationship with the Custodian covering all (or as many as possible) the locations he needs settlement for.

3.4 Liquidity

A TMF will prefer to outsource settlement to the Custodian that has the most clients. The Custodian with the most clients will be able to minimise the actual settlement movements through internal book transfer settlement netting and should also more easily be able to reduce settlement failure rates.

3.5 Fees

A TMF will want to use the Custodian who provides the lowest fees. The TMF is more likely to get competitive fees from a Custodian who is involved in multiple markets. The Custodian will then be able to leverage its investment in time, legal and regulatory costs and connections where he is providing services across multiple markets. This should provide a more balanced structure for markets where the Custodian is present.

3.6 Realignments

A TMF will want its Custodian to have a direct link for settlement with the issuer CSD, usually the home country CSD for the securities listed on local regulated market (CREST for London Stock Exchange, Euroclear France for the Euronext French market segment, etc.)

If the Custodian does not have direct links to the issuer CSD the TMF is likely to be passed the costs for realignment of securities between CSDs or the cost related to the local custodian the Settlement Agent is working with.

3.7 Risk Management

A TMF will prefer to consolidate his activities from a risk management approach (i.e. legal risk, connectivity complexity, straight through processing) into the least possible number of Custodians. As this is the case, the same elements as discussed in section 2 apply.

4 Multilateral Trading Facilities (MTF) or Regulated Market (RM) partnering with a Central Counterparty (CCP) or a Custodian acting as Settlement Agent (SA)

4.1 Assumptions:

In this paragraph we assume that:

- (i) the RM or MTF will offer trading services in a range of ISINs (covering different nationalities) for which clearing and/or settlement liquidity currently reside with different providers;
- (ii) the RM or MTF wish to offer post-trade services to their markets participants, such as the automated routing of clearing and settlement instructions to certain selected providers.

4.1 Membership

The MTF or RM will prefer to link with the CCP/SA whose members/participants already represent the largest possible number of the TMFs and prospects of the MTF/RM.

4.2 Regulatory

With the arrival of MiFID and the possibilities for cross border trading that are opened up, it is probable that in order to ensure compliance with some of the national legal and regulatory requirements MTF/RM will prefer to link with the CCP/SA having the same regulator(s) as the MTF/RM activity, although this may be hard to maintain when a wide range of solutions must be offered.

4.3 Liquidity

The MTF or RM will prefer to link with the CCP already offering clearing for the tradable set of ISIN codes. The MTF/RM will leverage clearing and settlement liquidity at the CCP.

4.4 Fees

The MTF/RM will choose to partner with the CCP that charges the CMF the same fee for clearing trades matched on the MTF/RM that the CCP charges the CMF for trades matched on the home market of the ISIN.

4.5 Realignments

The MTF/RM will choose to partner with the CCP/SA that operates in the least complex way and thus that operates direct links with the issuer CSD that they clear/settle.

4.6 Risk Management:

In order to reduce time to market the MTF/RM will seek to partner with the CCP that already has experience with the set of securities the MTF/RM offers to trade. The MTF/RM will try to avoid partnering with the CCP that needs to build and seek regulatory approval for a set of additional risk management procedures. Also when appointing a SA the MTF/RM will seek to avoid that the SA has no proven track record for settlement in the CSDs he is appointed for.

4.7 Connectivity:

The MTF/RM will prefer the CCP/SA that has no unusual requirements from a connectivity standpoint. Most CCP/SA will provide direct and indirect communication links. Costs for these will vary according to criteria such as capacity, configuration and location.

5 Conclusion

This White Paper gives an overview of the elements that should be taken into account when deciding upon the most efficient clearing and settlement solutions for (cross-border) trades.

It shows that RM or MTF that wish to attract market participants and add value to their business should use exactly the same criteria in developing their post-trade solutions as their market participants themselves use.

Execution services are clearly a separate market from clearing and settlement services. MiFID aims to foster competition and lower trading costs for the end-customers by increased competition between execution venues.

New platforms that provide up-front lower fees for execution services but that do not take into account the reality of the current clearing and settlement environment run the risk of providing a poor service to their customers, as the total cost of the trade is likely to be bigger than on the ostensibly "more expensive" home market that makes use of the existing "clearing and settlement liquidity".



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