

European Shadow Financial Regulatory Committee

Re-Plumbing European Securities Markets

Statement No. 12

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The current wave of mergers among securities exchanges has knock-on implications for the structure of securities clearing and settlement in Europe. Until very recently, clearing and settlement systems functioned as utilities serving national needs within Europe's segmented and state-protected capital markets. These systems are now being adapted to the needs of an integrating European securities market. A key question is what role European authorities should have in the restructuring process.

There is widespread recognition across the securities sector that the economies of scale and network effects which characterize the clearing and settlement function are far from being fully exploited in Europe. The barriers to consolidation in clearing and settlement, typically performed by Central Securities Depositories (CSDs), extend well beyond those which derive from distortive government action in the areas of regulation and taxation. They derive fundamentally from the current structure of the market, which is defined by vertical integration of the trading and settlement platforms in a number of major market centres – perhaps most notably, Germany, where Deutsche Börse controls half of Clearstream and has expressed a clear desire to own it outright. The creation of such 'vertical silos' has the effect not only of blocking cross-border mergers of CSDs, but erects a major barrier to competition among exchanges and trading platforms. Creation of such a barrier is, in fact, a significant motivation for the creation of such silos: exchanges owning CSDs can make access to them prohibitively expensive for other trading-system and CSD operators wishing to compete for order flow in the same securities.

It is such concerns that have led to proposals, notably by London Stock Exchange Chairman Don Cruickshank, for the European Commission to dismantle vertical silos and to 'explore how it might force Europe to use a single CSD'.¹ The goal is to create a highly regulated monopoly organized along the lines of the US Depository Trust and Clearing Corporation (DTCC), an industry mutual organization mandated by the Securities and Exchange Commission after it obliged US exchanges to divest themselves of their settlement arms three decades ago.

The European Shadow Financial Regulatory Committee (ESFRC) does not believe that empowering the Commission to create such a quasi-nationalized industry utility is in the interests of investors or corporate equity issuers. Given the rapid pace of technological advance in the securities sector, no governmental body is capable of substituting its commercial or technological foresight for the critical stimulus of competitive market forces.

¹ *International Finance*, Summer 2001.

We do believe, however, that the creation of vertical silos is inimical to the goal of creating a single European securities market, featuring robust cross-border competition among exchanges and other trading service providers. We believe further that efforts at the European level to regulate the access policies and charges of CSDs controlled by national exchanges, which are currently near-monopolies in their domestic listed securities, are unlikely to be effective. The European Commission has recently suggested that the barriers to competition created by vertical silos be reduced by giving market participants access rights to the CSD of their choice. The effectiveness of such rights would, however, be seriously undermined by necessary exceptions and conditions allowed for by the Commission. Furthermore, the regime proposed by the Commission would inevitably lead to burdensome and impractical regulatory involvement in CSD pricing decisions.

The ESFRC therefore calls for an alternative regulatory regime with a view to (a) maximizing the incentives of CSDs to exploit economies of scale and network effects implicit in their services, and (b) facilitating open and direct competition among trading platforms for European securities.

We propose to bar EU exchanges from owning controlling stakes in CSDs. This may require some exchanges partially to divest themselves of holdings in CSDs, but would not otherwise involve the Commission or any other government body in the day-to-day regulation of the behaviour of exchanges with respect to their commercial relations with CSDs and other exchanges.

We anticipate that such action would, on its own, stimulate a rapid cross-border consolidation of CSDs in Europe. Once the CSDs can no longer be used by exchanges as competitive barriers, they will be compelled to consider mergers as a means of survival: those that do not participate in the consolidation process may quickly find themselves at a competitive disadvantage vis-à-vis larger scale and lower cost rivals. There are clear parallels with the global custodian industry, which has seen relentless consolidation and falling margins.

Therefore, we see no need to pre-empt this market consolidation through the imposition of a single CSD for Europe as proposed by Mr. Cruickshank. It is better by far that the industry should be reshaped on the basis of market incentives and needs.

We believe that our proposals offer the best prospect of ensuring that the CSD market is contestable and competitive. However, if over time consolidation were to tend towards monopoly – at present a distant prospect – it would be appropriate at that stage to consider regulatory safeguards.

We further believe that the EU's regime of 'mutual recognition' combined with 'home country control' is optimally suited to competition-driven consolidation of the CSD industry. Competing CSDs will have a maximum incentive to domicile themselves in national regulatory jurisdictions which allow them to operate at maximum efficiency: for example, we expect that jurisdictions in which the sanctity of netting agreements is inviolate in bankruptcy proceedings will have a distinct competitive advantage over those which do not provide equivalent legal protection for netting. This will rightly drive CSDs into netting-friendly jurisdictions, and encourage other governments to reform their bankruptcy laws accordingly.

The European Shadow Financial Regulatory Committee is a group of academics and other experts whose mission is to follow and analyse critically the existing and evolving regulatory framework for financial markets. The Committee gratefully acknowledges financial support by PricewaterhouseCoopers. However, the Committee is fully independent and autonomous in drafting its statements.