

RESPONSE OF LCH.CLEARNET TO CESR/ESCB CONSULTATION

STANDARDS FOR SECURITIES CLEARING AND SETTLEMENT IN THE EU

Ahead of the finalisation of their merger, Clearnet and LCH offer joint comments on the CESR-ESCB consultative paper. We write, of course, in our capacity as specialist central counterparty clearing houses. With some reluctance, we use the abbreviation CCP; but would note that it was introduced only after the second wave of stock exchange clearing began in Europe in the late 1990s, and is thus narrowly associated with just one product, cash equities, amongst many cleared by our two organisations.

Background

Clearnet and LCH appreciate efforts at European level to remove barriers so that customers can transact business more efficiently and accordingly welcome the opportunity to respond to CESR/ESCB's draft Standards. Attendance at the open hearing clarified many of the issues for us.

Timetable: Clearing Houses

We note the following imminent developments:

1. Commission action pursuant to its "Communication" of last year is expected in November. We would hope that this will lead to common principles for the supervision of CCPs across Europe.
2. CPSS/IOSCO are engaged in further work on clearing houses.
3. The revision to the Investment Services Directive is likely to be enacted soon.

We also note that the Standards confine themselves to the clearing and settlement of securities, a scope dictated by the fact that CSD/SSS activities are confined to securities. It seems to us that any Standards for CCPs ought also to take into account the full product scope of CCP business, which in the case of Clearnet and LCH, and other clearing houses in Europe, includes commodity-related clearing.

It is clear that CESR/ESCB will be doing more work on CCPs, in the immediate future. This work is likely to cover both the clearing of securities (and of derivatives based on securities) and that of commodities: addressing either aspect in isolation may lead to inconsistencies of treatment. Given the coming developments, it would seem impossible for any current Standard on CCPs to achieve the first objective behind the Standards ("To provide a consistent basis for the adequate regulation, supervision and oversight of securities clearing and settlement systems and other relevant securities service providers in the European Union".)

As an interim step, it seems possible to apply the standards relevant to CCPs to all of those entities designated as “Systems” pursuant to Article 2 of the Settlement Finality Directive (98/26/EC) (such designation being typically construed to apply narrowly to securities business, although the recitals of the directive make it clear that CCPs with non-securities business (such as Clearnet and LCH) may be designated.)

Structure and methodology of the Standards

Each Standard is composed of the standard itself, key elements and an explanatory memorandum. At the Open Hearing it was stated that the key elements would be checked as part of the assessment methodology. It was helpful for that point to be made, as it was not clear in the text. As other commentators noted, the line between “soft” and “hard” law is often imprecise. If the explanatory memorandum is to have real value, then it too needs to be concise. For example, because of the length of its explanatory memorandum, Standard 4, as it stands, may ultimately lead to less clarity. One danger is that additional analysis/discourse may be the source of confusion and obfuscate the Standards themselves. Another is that individual regulators interpret the references in the explanatory memorandum in different ways. For this reason it is recommended that any text over and above the Standards be kept to a minimum.

Standard 1: Legal Framework

As discussed at the Open Hearing, we would be reluctant to incur the further cost of commissioning new legal and accounting opinions (see paragraph 29 in particular). Whilst we are happy to provide information to the market participants by way of brochures/website, we are hesitant to go much further. An opinion is a response to a specific question or questions, such as: (a) is a procedure effective? or (b) does the procedure have any weaknesses? A one-word answer to (a) may be less than illuminating. For a CCP (or a CSD or an exchange for that matter) to provide a list of exploitable weaknesses at (b) would also be undesirable in terms of systemic risk.

If the Standard is to suggest that an opinion should be made available, then the references ought to specify the precise question that the opinion needs to address, instead of being so general.

Paragraph 31 stipulates that CCPs should be designated under the Settlement Finality Directive. Whilst we both would rather see legislation in place to enable us be designated specifically as clearing houses, designation as “systems” under the Directive does offer additional protection; and Clearnet and LCH are aware of only one European CCP – Clearing Bank Hannover – whose activities are exclusively confined to commodity futures and is therefore ineligible for designation.

Standard 4: CCPs

The thrust behind the Standard, key elements and explanatory memorandum is that (existing) CCPs rigorously manage their risks. Much of the rest of the Standard's five pages extols the benefits of CCPs and explains how they work.

As noted above, further developments are expected on CCPs in the near future. When these can be taken into account, more substance may be added to the standard.

Standard 18: Supervision/Mutual Recognition etc

Standard 18 appears to be based on the assumption that supervision of clearing will be based on the currently established principles of mutual recognition. This seems to be wrong, unless the text of Article 43(2) of the revised ISD has been amended.

That Article seems to preserve almost all supervisory power with the CCP's home state supervisor. This is desirable. As a general principle, supervisors of regulated markets will receive the information they require from the market concerned. Only in exceptional cases should they have recourse to the CCP's supervisor. There will be no supervisory power on the part of supervisors of remote markets over a foreign European CCP. Article 43 seems to mean that the French and UK authorities (only) would respectively monitor the compliance of each of our two CCPs' compliance with any Standards.

Departing from the principles which have now been set out at Article 43 has created a number of difficulties for Clearnet in clearing the non-French Euronext markets. In particular, responding to the concerns of non-French supervisors of the Euronext markets has become a significant and distracting burden on Clearnet's management. The Portuguese and Belgian regulators insist on Clearnet maintaining a local banking branch. (Clearnet does not understand whether the requirement arises by virtue of its access to central bank money, or by virtue of it acting as CCP for the local market). For reasons which are equally opaque to Clearnet, if a FSA-regulated member of Clearnet wishes to clear (not trade) the Euronext Amsterdam market then it has to join that market. (Some of these requirements are not only inconvenient, but also costly - the increase in tax liability through having to operate a banking branch in Portugal is significant.)

In contrast, in clearing the MTS Italy regulated market, the supervisors of MTS have only exercised power unseen by Clearnet, either dealing with MTS or with Clearnet's French supervisors. There have been no adverse consequences of this approach.

We are uncertain as to the suggestion at paragraph 21 of the consultation's introduction. Whilst it would be helpful for the Group to ensure the appropriate co-ordination and transparency as to the assessments, we do not believe that the Group should be granted any direct supervisory power, unless that power were to be removed from the national supervisors, which does not seem to be envisaged. The scope of the co-ordination and monitoring role needs to be clarified.

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