

Choice with benefits

Interoperability between clearinghouses is a positive development for the markets, writes **Robert Barnes** of UBS

The trend towards smaller trade sizes has caused the cost of clearing and settlement in the cash equities markets to soar. Market participants often pay for these services according to the number of trades they execute. In a context where the number of trades is rising, the clearing and settlement cost of trading the same value is going up year-on-year.

Into this situation comes the concept of interoperability which, in simple terms, means consolidating clearing and settlement activity to take advantage of volume discounts to reduce costs. Interoperability also gives market

participants the flexibility to trade the same instrument anywhere and settle in one place. This offers the potential to promote new business for products across geographies.

The concept of clearing interoperability was introduced in Europe and has given rise to the much talked-about central counterparty (CCP) clearinghouse “user choice” model. This allows international users to consolidate their clearing across markets in the CCP which has the best affinity with their commercial profile and without imposing switching costs on those domestic members that wish to remain with the incumbent.

For example, if a stock matches on three platforms which do not share a CCP, the user pays three net settlement fees per stock per day, due to one net message per CCP. With interoperability, a firm that consolidates all trades in that stock to its CCP of choice will reduce its settlement fees by two thirds in this case.

A meaningful competitive framework includes willingness by:

1. Exchange or multilateral trading facility (MTF) to provide trade feed to CCP(s) requesting interoperability.
2. CCP incumbent to participate in interoperability.

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Full interoperability of CCP user choice is helped by:

- (i) Tariff comparability where fees can be translated into a proportion of value traded.
- (ii) User endorsement as a business filter for interoperability to avoid frivolous requests.
- (iii) Faster-moving timetables to allow competitive new entry.

Technically, most interoperability projects and the act of switching are straightforward to implement. Delaying the introduction of full interoperability disadvantages market efficiency by preventing access to the obvious benefits of multi-market post-trade consolidation via the user choice model.

UBS MTF case study

On July 29 2011, UBS MTF became the first MTF to offer full interoperability of CCPs, SIX x-clear and EuroCCP. Full interoperability allows 100 per cent predictability that a matched order will clear through the trader's CCP of choice.

Joining UBS MTF qualifies firms for immediate clearing fee and collateral incentives announced by its CCPs. The

value of matched trades surged such that the MTF ranking jumped from ninth since launch to fourth (August), second (September), third (October) and second (November) in the Thomson Reuters Equities Market Share report which tracks 16 external venues matching pre-trade non-displayed or 'dark' liquidity in Europe.

Based on UBS's experience of switching CCPs in the Swiss and London markets (2005 and 2008, respectively), our views are that a multiple CCP user choice model is the safe and simple way to aggregate matched flows of different stock names

across venues for immediate single volume discount benefits of reduced transaction and collateral costs.

UBS MTF also has the capability to trade 142 of the most liquid ETFs from Switzerland, Germany, France, the Netherlands and the UK. The opportunity post-Lehman where investors wish to mitigate broker counterparty risk is to encourage ETFs to match on order-book and clear safely in a CCP model with the potential for price improvement. UBS MTF added depository receipts to complement this offering and international user demand.

The global perspective

The European Commission's *Competition in EU Securities Trading and Post-trading: Issues Paper* stated: "CCP services could – and probably should – operate in a competitive environment provided issues of interoperability are overcome." Helpfully, MTFs and exchanges are moving this way and interoperability is set to become the rule rather than the exception.

During the financial crisis, business on exchanges with CCPs performed well. This included markets like SIX Swiss Exchange and the London Stock

Exchange that feature the interoperating CCPs of LCH.Clearnet and SIX x-clear, where users clear through their CCP of choice.

European exchanges and European MTFs are delivering or plan safe implementations of interoperability within the prudent revised regulatory framework. In the US there is one currency, one clearing and settlement model and one set of rules. Europe is more complex but has solved the puzzle of how to trade the same name in two or more countries and settle at home. Asia, where exchanges have recorded more orderbook value traded than European ones since 2009, could also benefit significantly from adopting the user choice model.

To promote growth of global liquidity, one opportunity is to extend this model to equities and equity-related products like ETFs to allow investors to diversify their risk by geography. As more international markets embrace clearing choice for efficiency, one can envision global equities evolving towards the way developed currencies can trade 24 hours and settle in one place. ■

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Career in brief

Robert Barnes is chief executive officer of UBS MTF, a segregated non-displayed MTF with CCPs that can settle trades of more than 3000+ securities from 15 countries into their respective home depositories. He joined the proprietary trading team at Swiss Bank Corporation in 1994, gained experience 'downstairs' on the Liffe derivatives floor and 'upstairs' trading special situations via brokers. He chaired the Securities Trading Committee of the London Investment Banking Association from 2004-2009 and continues to represent UBS on user advisory groups for a number of stock exchanges, regulatory committees and pro-competitive initiatives world-wide. He holds a BA from Harvard and a PhD from Cambridge.