Creating Links

The never ending quest to create a more liquid market has lead many exchanges around the world to focus on enhancing their post-trade services. This is particularly relevant among many FEAS members who are grappling with how to create foreign access while ensuring that liquidity stays in their home market.

Brokers in most markets must currently go outside their home exchange to trade foreign securities. At the same time, foreign investors have no direct way to buy securities on the instrument’s home market. Traditionally, this has been due to regulatory barriers and member firms aiming to protect the market, particularly with regards to post-trade processing.

To solve this and promote growth and efficiency in their capital markets, some exchanges are establishing regional cross-border collaborations. Seven Asia-Pacific exchanges, for example, have formed the ASEAN Exchange alliance, which will allow for more seamless trading when fully set up. Similar efforts are underway to create regional integration in Latin America. In Europe, the European Union has addressed this issue with new regulations that will open up the access between post-trade providers. Central cross-border clearing services are, therefore, now being established among cash equities markets.

In the Nordic and Baltic region, NASDAQ OMX was successful in creating the technical and regulatory infrastructure to bring together the Nordic and Baltic markets. Work began as far back as 1995 when a close cooperation between the Swedish and Finnish derivatives exchanges led to providing investors with the ability to trade Nordic derivatives – including Swedish, Danish, Finnish, Icelandic and Russian – on a single market. It continued a few years later with links established to Oslo Børs and later also to EDX/London Stock Exchange.

A key factor in the Nordic success story was our ability to be a first mover and innovate with creating post-trade linkages between different markets. The clearing link between NASDAQ OMX and LCH was the first of its kind in the world. Equally important were the contractual and regulatory relationships between the various markets that established the terms and conditions of working together.

Since the initial cooperation, NASDAQ OMX Nordic has been striving to link markets together for both cash and derivatives. Today, NASDAQ OMX Nordic runs exchanges in seven different European jurisdictions on a single trading platform.

Toward that end NASDAQ OMX Nordic implemented CCP clearing on its cash equities markets in Stockholm, Helsinki and Copenhagen in 2009. Concurrently NASDAQ OMX Nordic upgraded its trading platform to INET technology. This dual effort has attracted additional remote membership, leading to increased order flow to our markets. Since 2009, remote members’ market share in terms of turnover almost doubled from 35% to 65%. Today, CCP clearing encompasses large cap companies listed in Stockholm and Copenhagen and all companies listed in Helsinki. Norwegian shares traded in Stockholm and ETFs listed in Stockholm and Helsinki are also CCP cleared.

From a technical perspective, setting up post-trade service for cash equities is fairly straightforward. The key is to align the interfaces with international standards, generally recognized as those followed by the leading financial centers. Common protocols, like FIX, ISO 15022 or ISO 201, should be used. This way all the CCPs that want to connect to a particular market can...
do so on an equal basis. Once technical access is created for one CCP, establishing future connections becomes a configuration, not development, issue greatly simplifying the process. It can get more complicated for options which require more sophisticated data feeds, especially if activities need to be coordinated across time zones.

Commercial and regulatory considerations can vary greatly among markets and are generally more challenging to harmonize. As with technology, rules and regulations should be aligned with international standards. In addition, legal agreements generally have to pass muster with each entity’s home regulator, and requirements can vary greatly by market jurisdiction.

Lessons from the Nordic Exchange

NASDAQ OMX Nordic established a set of criteria which it used in the cash CCP selection and implementation process. Broadly speaking, the criteria and the actual implementation fall into three basic categories: connectivity & IT, legal and regulatory, and member readiness and communication. Across all, there has to be a common understanding of the rules and procedures among stakeholders.

Connectivity & IT

As a first step, exchanges and CCPs need to ensure that their interacting technical systems are aligned. What message protocols and technical specifications are to be used? Is the CCP able to clear all instrument types the exchange requires? Can the system generate the data needed for the CCP to process certain instrument types? The trading platform and CCP must have a common understanding of all CCP-eligible instruments and the members who may trade on those instruments. There should be no discrepancies between exchange and CCP databases. This ensures that the CCP receives only valid trades from valid members.

From an operational perspective, procedures, technical assistance and contingency planning must be coordinated. Communication procedures for adding new members and other changes need to be established.

Other operational issues include system speed and capacity (i.e. the number of trades per second the CCP can handle), the CCP’s ability to handle non-standard settlement cycles and -- critically important -- its risk management capabilities. A key risk management consideration is how often the system recalculates total exposure for all clearing participants. Ideally, this should be as close to real-time as possible.

Legal & Regulatory

An important consideration here is whether existing exchange rules need to be adapted to ensure they are coordinated with the CCP rules. Prior to starting this process, for example, NASDAQ OMX Nordic rules did not recognize the existence of a CCP; hence, we needed to adapt those to incorporate the CCP framework.

The approval of home country regulators is also imperative. The process will vary by jurisdiction. Some countries, for example, require that CCPs obtain a license, necessitating a formal approval process. At NASDAQ OMX Nordic, we converted three exchanges in three different jurisdictions to a CCP post-trade service simultaneously. For NASDAQ OMX Nordic, it was also important for the CCP to become a member of the local CSDs. This way, the CCP becomes a direct participant in settlement, creating a more efficient process and safeguarding a commitment to the local market.
Member Readiness and Communication

While members generally want to reap the risk and cost reduction benefits of CCP processing, the switch from bilateral to central clearing means a total change in members’ trade flow processing. Systems and procedures must also be aligned on the member side, often requiring extensive changes to member systems that handle post-trade settlement. The exchange facilitates the post-trade services from the CCP, and members look to the exchange for advice and communication. The CCP is often not locally based and representatives might not be fluent in the local language. So the exchange plays a central role in the coordination between all stakeholders.

In addition to establishing an extensive communications plan, NASDAQ OMX Nordic managed a series of local working groups where all stakeholders – including members, CCP and the local CSDs – worked together to address any changes needed in local market settlement practices.

Finally, member testing is critical to success. We worked with the CCP and CSDs, to create an extensive online test environment prior to launching central clearing.

Conclusion

Cross-border clearing capabilities are critical to improving market liquidity and to continuing to attract remote members. Cross-border clearing capabilities are critical to improving market liquidity and to continuing to attract remote members. CCP clearing addresses this issue while improving efficiency and risk management for members. The process of setting it up and establishing connectivity, however, can be arduous and requires good cooperation and communication among all stakeholders.

KEY LINK INTERFACES AND PROCESSES FOR DERIVATIVES

While the basic process for establishing CCP clearing in derivatives markets is similar to equities, derivatives have more complex needs. From a technical perspective, some additional considerations for derivatives include:

- Administration of reference data
- Trades
- Amendments (cross clearinghouses)
- Reconciliation
- Prices for margining, variation margin and expiration/exercise
- Cross clearinghouse exercises (for options)
- Statistics (i.e. open interest)
- Settlement and collateral arrangements (if applicable – also for physical delivery)
- Fees and fee splits
- Time offsets in clearing cycle between parties
- Corporate actions/capital adjustments (if applicable)
- Long position reporting
- Cross-border give-ups/amendments

For derivatives markets, however, the greatest challenges have more to do with process, risk management and regulation than technology. The main issue for CCP clearing is interoperability between clearinghouses. The two parties settle trades at different clearinghouses, creating the need for detailed processes outlining responsibilities and how the two clearinghouses will work together. The risks are much greater for derivatives, so putting together the appropriate legal framework for how to handle the risk between clearinghouses is critical.

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