OFFICE OF FAIR TRADING

Anticipated merger of Banque Centrale de Compensation SA and the London Clearing House Ltd

The OFT's decision on reference under section 33 given on 11 August 2003

PARTIES

Banque Centrale de Compensation SA (Clearnet) is active in the provision of central counterparty (CCP) clearing services for various products. Clearnet is currently owned 80.2 per cent by Euronext NV (Euronext), that in turn, owns and operates exchanges in Amsterdam, Brussels, London (LIFFE), Lisbon and Paris. In the year to end December 2002, Clearnet's UK turnover was approximately £25.3 million.
The London Clearing House Ltd (LCH) is active in the provision of CCP and other clearing services for various products in the UK. It is independently owned and governed 75 per cent by the member firms for whom it provides CCP services and 25 per cent by the three London exchanges (IPE, LIFFE and LME) whose products it clears. In the year to end October 2002, LCH's UK turnover was approximately £183.6 million.
LCH.Clearnet Group Ltd (LCH.Clearnet) has been set up as an independent UK incorporated holding company to acquire Clearnet and LCH.

TRANSACTION

It is proposed that LCH.Clearnet will acquire 100 per cent of each of Clearnet and LCH. LCH.Clearnet will be owned 45.1 per cent by users, 41.5 per cent by Euronext, 9.8 per cent by Euroclear, 2.7 per cent by LME and 0.9 per cent by IPE. Initially Clearnet and LCH will remain distinct from each other, but be integrated in phases during the next three to four years.

This is a proposed transaction. It was announced on 25 June 2003. The 30-day statutory deadline is 11 August 2003.

JURISDICTION

As a result of this transaction Clearnet and LCH will cease to be distinct. The parties overlap in the supply of clearing services and the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. A relevant merger situation has been created.

RELEVANT MARKET

The parties overlap in the provision of CCP clearing services.

Product market

Clearing services comprise the process of transmitting, reconciling and confirming payment orders or security transfer orders prior to settlement, and the establishment of a final position for the settlement of a trade. Clearing services can be provided by a clearing house, a central securities depository (CSD) or, in the case of cross border trades, an international central securities depository (ICSD) or global custodian bank.

In addition to clearing services, clearing houses such as LCH and Clearnet offer CCP services to clearing members in respect of instruments traded bilaterally between members, on various exchanges and on automated trading systems (ATSs). A CCP provider takes on the liability for a trade in the event of one of the parties to the trade defaulting and reduces the risk buyers and sellers have to bear. A CCP also provides post-trade anonymity for member buyers and sellers. Furthermore, CCPs offer netting services which reduce settlement costs by greatly reducing the credit risk exposure, margin requirements, and liquidity needs of buyers and sellers, as well as the final number of transactions that have to be settled.

The network effects to be derived from concentrated clearing and netting imply that it is beneficial to rely on one clearing house for both services. As a result, clearing agents such as CSDs and ICSDs, who do not offer CCP services, do not act as a competitive constraint on clearing houses that do offer CCP services.

There is, however, some scope for competition between clearing houses for off-exchange or over-the-counter (OTC) trades and many ATSs use more than one CCP provider. Nevertheless, the more concentrated CCP clearing is, the greater are the opportunities for users to save on the amount of margin required to clear their trades. This implies that it would be beneficial for exchanges to concentrate all of their clearing in one particular CCP clearing house.

Whilst the choice of clearing house rests with the exchange, switching to another clearing house would require approval from its members. Providers of CCP services in the UK require regulatory approval from the Financial Services Authority (FSA). Switching is also considered to be costly in terms of systems compatibility for the exchange and its members, and third parties estimate it may take 6-18 months to switch.

Although there are no examples of switching between European clearing houses, the Chicago Board of Trade (CBOT) in the USA has recently announced that it was moving its clearing business from the Board of Trade Clearing Corporation (BOTCC) to the Chicago Mercantile Exchange (CME). More recently, the London Stock Exchange (LSE) who use LCH's services, has sent requests for information to four potential clearing providers, although press reports suggest that such a move has met significant resistance from LSE members who will have to bear much of the switching cost. For exchanges therefore, the difficulties of switching between clearing houses makes it unlikely in the short term, although not impossible in the longer term.

As a result of the above considerations, for the purposes of this decision the relevant frame of reference is considered to be the provision of clearing services through a CCP.

Geographic market

Although clearing houses have traditionally operated on a national basis, the ability for exchanges to cross national boundaries and clear their trades with clearing houses based in other countries suggests that the relevant geographic frame of reference should be pan-European at least, and may possibly be wider.

Moreover, the scope for competition between clearing houses in respect of off-exchange trades is greater than for on-exchange trades. In this respect, the relevant geographic frame of reference for these trades is likely to be pan-European at least.

HORIZONTAL ISSUES

Market shares

The parties do not presently compete for the provision of exchange traded clearing services in the UK. In addition, as long as Euronext retains its own in-house clearing capability via Clearnet, it is not realistic to expect LCH to attract this business away from Clearnet. Similarly, Clearnet has no existing presence as a provider of CCP clearing services for on-exchange trades in the UK, and has no plans to establish or seek such a presence.

There is, however, some overlap in terms of CCP clearing provision for off-exchange trades or OTCs. Traditionally, OTC trades were settled bilaterally without the interposition of a CCP and although the demand for OTC clearing via a CCP has grown recently, it remains the case that less than 5 per cent of OTC trades are cleared centrally. In addition, OTC clearing accounts for less than 10 per cent of LCH's and Clearnet's total revenues. As a result, traders of OTC products have a wider range of clearing options open to them than traders of exchange-traded products.

The lack of competition for CCP clearing services on-exchange and limited use of such services off-exchange implies that the merger is unlikely to lead to a substantial lessening of competition at the horizontal level.

Barriers to entry and expansion

The network externalities of clearing trades centrally imply that barriers to new entry for clearing houses, and CCP services in particular, are very high. Furthermore, a new entrant would be unlikely to be able to attract the quantity of trades necessary to operate as efficiently and cost effectively as the LCH.Clearnet entity would.

Buyer power

The parties submit that the governance structure of LCH.Clearnet represents a balance between the interests of all users and exchanges and is aimed at ensuring that LCH.Clearnet will be responsive to the needs and interests of all members.

Third parties and particularly exchanges, however, have expressed doubts as to the level of influence they would have over LCH.Clearnet in practice. Given these doubts and the difficulties in switching between clearing houses, countervailing buyer power is likely to be limited.

VERTICAL ISSUES

The vertical issues that arise from this merger stem from the interest that Euronext will retain in LCH.Clearnet. Whereas Euronext currently owns 80 per cent of Clearnet which currently clears trades of the Euronext exchanges of the Netherlands, Belgium and France, its shareholding of the merged entity will be 41.5 per cent .[1] As a result, some exchanges expressed concerns about Euronext's ability to influence LCH.Clearnet to its own advantage and against the interests of its rival exchanges. In particular they are concerned that Euronext might gain more favourable clearing terms through bespoke contracts between itself and LCH.Clearnet and through the prioritisation of proposals for new products, and that Euronext may have access to confidential information about its rivals.

Clearing services play an important role in competition between exchanges, particularly as they seek to develop new products and lines of business. Any advantages in clearing services that Euronext could gain over rival exchanges would give it a competitive advantage. Therefore, Euronext may have an incentive to ensure that new projects are prioritised in its own favour. Such discrimination would make it difficult for

[1] Euronext also has a 1.83 per cent share in Euroclear which will have a 9.8 per cent interest in LCH.Clearnet. In 2004 Euronext's share of Euroclear will increase to 2.43 per cent.

any other exchange to bring on-stream a new product that competes with existing Euronext products and could raise their costs relative to Euronext's costs.

It is not clear, however, that such a strategy would be beneficial or profitable for LCH.Clearnet itself. The parties have argued that much of their business is predicated on building trust with their customers and spreading the reach of products and that any abuse would erode their integrity. This would result in customers taking their business elsewhere, over the longer term.

Moreover, Euronext's ability to influence the strategy of the merged entity to its own advantage is limited as a result of the voting rights, board structure, its Articles of Association and its contracts with exchanges. Its voting rights are capped at 24.9 per cent and its remaining voting interests (relevant votes) are vested in an Independent Third Party whose conduct in exercising these votes is governed by terms of reference. These voting caps are scheduled to be lifted after the first 5 years unless they are extended by a simple resolution i.e. agreed by 25 per cent of shareholders excluding relevant votes. Any relaxation in these voting caps requires a special resolution i.e. approval by 75 per cent of shareholders present.

In respect of its influence on the Board, Euronext will be entitled to appoint 4 out of 19 directors. The remaining positions on the Board will comprise 6 directors appointed by users, 2 by exchanges (excluding Euronext), 2 by Euroclear, 3 independents and 2 executives. This Board structure implies that Euronext will not have the ability to veto board decisions.

Furthermore, safeguards included in the company's Articles of Association are intended to ensure the neutrality of the LCH.Clearnet Board and prevent Euronext from being privy to confidential information. Directors are obliged to take account of the interests of all members and exchanges and to comply with confidentiality requirements. Any conflicted directors will be excluded from receiving information on the issue on which they are conflicted, from attending meetings and from voting on the issue. A Committee of Independent Directors will adjudicate on conflicts of interest and third party complaints. Finally, users[2] are to be included on key management committees[3] including the Audit, Risk and Nomination committees.

Key commercial decisions over prioritisation of new products and discussions in relation to specific exchanges are to be handled by the management and the Board. The resources allocated to the development of new products will be determined by bilateral contract between LCH.Clearnet and the relevant exchange.

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[2] The parties wish to clarify that users or user directors will be included on these committees.
[3] The parties have noted that these are board committees although they do not comprise all LCH.Clearnet board members.

The parties also submit that LCH provides clearing services pursuant to bilateral contractual arrangements with IPE, LME, LIFFE and LSE, all of which are broadly on the same terms. Individual tailoring of these contracts is based on commercial rationale in respect of LCH and fees are set on a per market basis taking into account the actual costs incurred to service the particular market place. LCH currently charges a flat fee for each transaction upon registration[4] and various other standard fees per transaction and will continue to use this charging structure post merger. Clearnet intends to move towards a flat fee structure for cash equities.

Euronext may be able to negotiate more favourable clearing terms than its rival exchanges but this is likely to be as a result of its vertical integration with, and contribution to, LCH.Clearnet's revenue stream rather than any unfair ability to influence LCH.Clearnet strategy.

LCH.Clearnet will make use of the transaction processing capabilities of the Clearing 21[5] (C21) software. Clearnet currently operates C21 under a sub-licence from Euronext Paris, which is itself the licensee of the Chicago Mercantile Exchange. The maintenance and development of Clearnet's IT infrastructure, including C21, is currently outsourced to Atos Euronext which is a joint venture between Atos Origine and Euronext. Some third parties were concerned that this relationship between the provider of C21 and Euronext would prevent LCH.Clearnet from responding to the technological requirements of users. In response to these concerns, the parties have stated that their contract with Atos Euronext is not exclusive and all future services will be negotiated directly with Atos Euronext[6] and not, as previously, via Euronext.

CUSTOMER BENEFITS

Third parties acknowledge that customers will realise significant benefits arising mainly from the network externalities that arise from the merger. The migration to harmonised operating platforms and the stated intention to reduce fees will deliver direct cost savings in the medium term. The parties believe that the merger will enable extensive netting to take place and result in a reduction of up to 95 per cent of the number of trades settled. The parties further submit that there will be indirect internal processing efficiencies to be realised by all members.

The move from LCH operating as a not-for-profit mutual to being part of a for-profit company has also been raised by some third parties as an issue although the parties submitted that LCH has been operating on a profit principle for some time already and have publicly announced that the LCH.Clearnet Group will share benefits between users

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[4] The parties wish to clarify that flat fees are charged in respect of exchange traded contracts.
[5] The parties wish to note that all references to 'Clearing 21' be followed by the registered trademark symbol Clearing 21®.

and shareholders by allocating 70 per cent of pre-interest and tax profits that exceed €150 million in any given year.[7]

THIRD PARTY VIEWS

All third parties believe the merger will deliver significant benefits to them, but some expressed concerns about the vertical relationship between LCH.Clearnet and Euronext. These concerns have been taken into account in the above assessment.

ASSESSMENT

The transaction qualifies in respect of the share of supply test of the Act. The parties overlap in the provision of CCP clearing services in Europe.

The lack of competition between the parties for CCP clearing services on-exchange and the limited use of such services off-exchange implies that the merger is unlikely to have a significant impact on horizontal competition. Notwithstanding third party concerns, there appears to be no strong incentive on the part of the merged entity to allow Euronext to influence strategic decisions in its favour. A complex governance structure also limits Euronext's ability to discriminate against rival exchanges via its shareholding or position on the board. Moreover, the governance structure safeguards users and exchanges interests.

The merger does not appear to result in a substantial lessening of competition within a market or markets in the United Kingdom for goods or services.

DECISION

This merger will therefore **not be referred** to the Competition Commission under section 33(1) of the Act.

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[6] The parties wish to clarify that negotiations are under way for ATOS KPMG Consulting Ltd. to provide these services to LCH.Clearnet in future.

[7] The parties wish to clarify that 70 per cent of pre-interest and tax profits exceeding €150 million are for the benefit of users, and 30 per cent for the benefit of shareholders which includes users.