ANTICIPATED ACQUISITION BY LONDON STOCK EXCHANGE GROUP PLC OF QUANTILE GROUP LIMITED

[✂] RESPONSE TO ISSUES STATEMENT

30 June 2022

1. INTRODUCTION

1.1 Having reviewed the CMA's Issues Statement, [✂] disagrees with the CMA's decision to focus the Phase 2 investigation exclusively on multilateral compression and not to consider the potential competition concerns that arise in relation to optimisation services. As explained below, LSEG has both the ability and incentive to foreclose [✂] margin optimisation services.

1.2 This paper sets out [✂] concerns in relation to optimisation services. In summary:

(a) LCH has a clear **ability to foreclose rivals** to Quantile from providing margin optimisation services. In particular:

(i) LCH has significant market power in the provision of clearing services for rates and FX derivatives and a growing market position in the provision of clearing services for credit derivatives;

(ii) LCH has the ability to foreclose rival optimisation providers in relation to trades that are not cleared at LCH (i.e. non-cleared trades and trades cleared at other CCPs). In order for an optimisation provider to be commercially successful *at all* it is essential that they have access to LCH cleared trades; and

(iii) there are a number of foreclosure strategies LCH could pursue in relation to rival optimisation providers, including:

(A) providing Quantile, but not rival optimisation providers, with access to LCH's SMART tool [✂] and/or on providing Quantile with data on more favourable terms;

(B) LCH could make data available to Quantile that is not made available to rival optimisation providers or alternatively make data available to Quantile in a more efficient manner and/or on more favourable terms;

(C) LCH could delay new product developments that benefit rivals and/or share details of new developments (as well as take-up of features) of rivals with Quantile;

(D) [✂]; and

(E) LCH could bundle the provision of clearing services with optimisation and compression services (as well as other LSEG services), making it difficult for rival optimisation providers to compete.

(b) LCH has a clear **incentive to foreclose rivals** to Quantile from providing margin optimisation services.

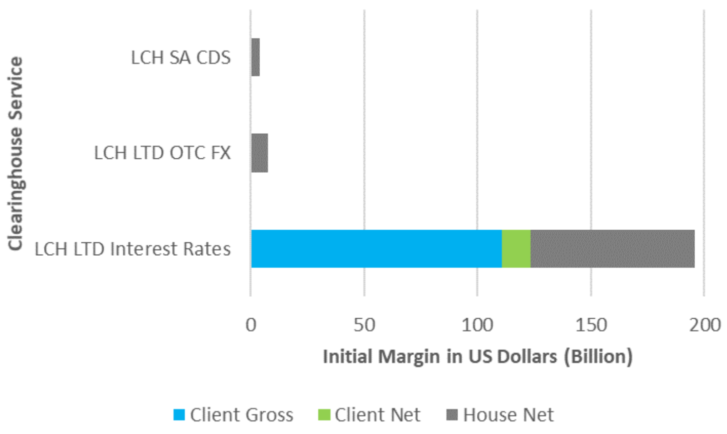
2. LCH HAS THE ABILITY TO FORECLOSE RIVALS

2.1 Margin optimisation refers to services that seek to reduce the collateral that a holder of a financial instrument has to deposit with a counterparty to cover some or all of the credit and market risk the holder poses for the counterparty. Whilst there are a range of different types of margin that can be optimised, the focus of the current case is on initial margin optimisation (the initial margin is the amount of collateral required by the CCP or trade counterparty to initiate a position).

2.2 Initial margin is relevant across asset classes and across cleared and non-cleared trades. [✂]

2.3 Figure 1 below shows the total amount of initial margin held by LCH in relation to Rates, FX and credit derivatives.[1]

Figure 1: Total amount of initial margin held by LCH at Q4 2021



Source: FIA CCP Tracker. Note: House Net, Client Net, and Client Gross reflect differences in account structure at the CCPs. "House Net" refers to initial margin required for positions held in respect of CCP members for their own house accounts. "Client Net" refers to initial margin required for client accounts that allow CCP members to net the requirements across multiple clients. "Client Gross" refers to the sum of all initial margin required for each client held within a gross client margin account.

2.4 Although rates represents the largest asset class by total initial margin, FX is the largest asset class in terms of optimisation activity (as measured by the initial margin reduction). However, optimisation of rates derivatives is growing faster than optimisation of FX derivatives. [✂]

2.5 [✂] concerns in relation to LCH's ability and incentive to foreclose rivals to Quantile focus on optimisation services for Rates, FX and credit derivatives as the asset classes in which LCH has (or in the near future will have) significant market power for clearing services.

LCH has significant market power in the provision of clearing services

2.6 [✂] submits that LCH has significant market power in the provision of clearing services for OTC IRDs and FX derivatives. In addition, LCH has a significant market position in the provision of clearing services for credit derivatives in Europe that will increase significantly in the near future. Each of these is addressed below.

<u>Clearing services for OTC IRDs</u>

2.7 [✂] fully agrees with the CMA's conclusion that LCH has significant market power in the provision of clearing services for OTC IRDs.[2]

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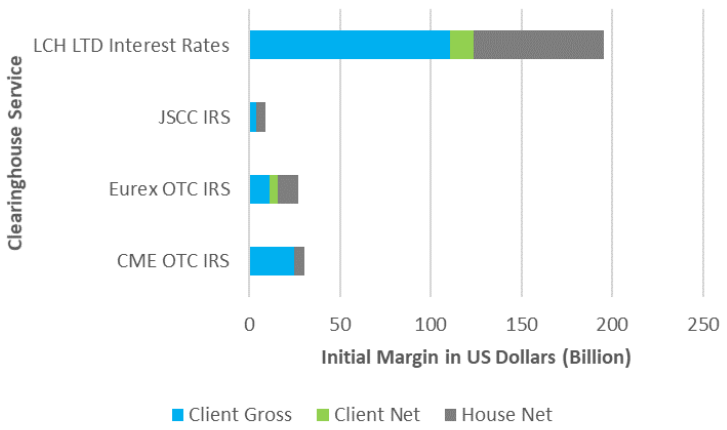
1 https://www.fia.org/initial-margin-service-level

2 CMA Phase 1 Decision, paragraph 77.

2.8 Whilst this conclusion was made in relation to a vertical theory of harm involving compression services, it equally applies to a vertical theory of harm in relation to optimisation services. To illustrate this, the Figure below shows the total initial margin held by different clearing houses in relation to rates derivatives.

Figure 2: Total amount of initial margin held in relation to rates derivatives at Q4 2021



Source: FIA CCP Tracker. Note: House Net, Client Net, and Client Gross reflect differences in account structure at the CCPs. "House Net" refers to initial margin required for positions held in respect of CCP members for their own house accounts. "Client Net" refers to initial margin required for client accounts that allow CCP members to net the requirements across multiple clients. "Client Gross" refers to the sum of all initial margin required for each client held within a gross client margin account.

2.9 Figure 2 shows that LCH is by far the largest clearing house in terms of margin held in relation to rates derivatives. Of the top four clearing houses for rates derivatives (LCH, CME, Eurex and JSCC) approximately 75% of total initial margin is held by LCH.

2.10 LCH's dominance in rates spans nearly all currencies (with the exception of JPY and LatAm Swaps). For example, a recent article by Clarus FT notes that LCH has a 99% market share in relation to GBP, CAD and EMEA Swaps; a 95% or more market share in relation to USD; and a 90% or more market share in relation to EUR and AUD.[3]

Clearing services for FX derivatives

2.11 [✂] disagrees with the CMA's conclusion at paragraph 170 of the Decision that LCH does not have significant market power in relation to clearing services for FX derivatives.

2.12 Whilst there are no regulatory requirements or obligations for parties to have OTC FX trades cleared at a clearing house, there is a strong incentive to clear trades through a CCP provider as a result of the following benefits of clearing:

(a) settling a trade through a CCP significantly reduces counterparty risk;

(b) market participants receive the benefit of netting multiple trades with different counterparties where their trades are cleared in the same CCP;

(c) banks are subject to capital requirements in most G20 countries, which means that effecting settlement through a CCP becomes more desirable vis-à-vis the requirement to hold additional capital to cover a non-cleared trade; and

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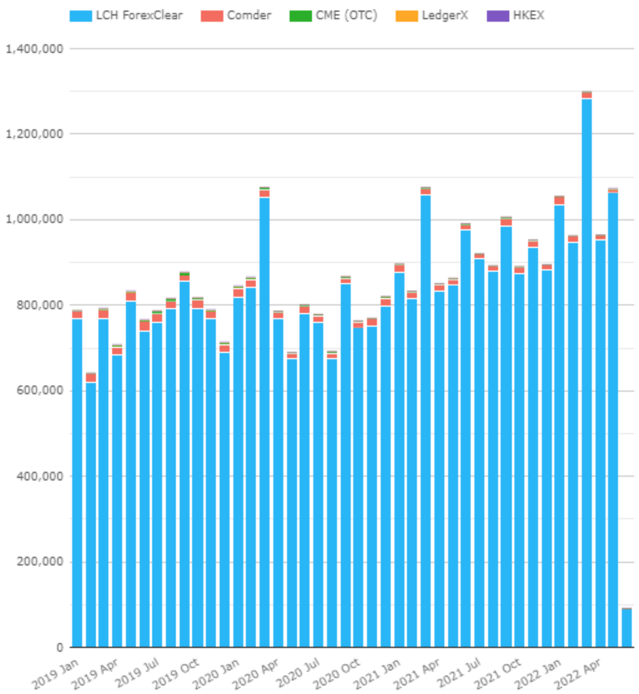
[3] https://www.clarusft.com/2021-ccp-volumes-and-market-share-in-ird/

(d) margin rules often require both parties to submit margin upon the execution of a trade that is not cleared through a CCP. Clearing trades at a CCP reduces the need for counterparties to post margin through the netting of offsetting trades.

2.13 This is consistent with a growing number of OTC FX trades being cleared at a clearing house. For example, the chart below shows that FX cleared volumes have been growing steadily over the last three years and also shows that LCH ForexClear accounts for the vast majority of FX OTC clearing.

Figure 3: FX cleared volumes, January 2019 – May 2022[4]



2.14 In relation to optimisation services specifically, Non-Deliverable Forwards (NDFs) account for the vast majority of optimisation services. [✂]

2.15 More than 95% of cleared FX derivative volumes relate to NDFs. Therefore, looking at FX derivatives as a whole will understate LCH's ability to foreclose optimisation services which are heavily weighted to NDFs which are the FX derivative most likely to be cleared.

2.16 Moreover, if the parties to an OTC FX derivative trade have made the decision to clear that trade, they have no other option but to use LCH. LCH is the leading global provider of OTC FX clearing, responsible for clearing more than 95% of cleared OTC FX derivatives trades globally. On this basis [✂] considers that LCH has significant market power in relation to the provision of clearing services for FX derivatives.

<u>Clearing services for credit derivatives</u>

2.17 The market for credit derivatives is regional in nature. At the moment, ICE is the main provider of clearing services for credit derivatives in both North America and Europe. However, LCH [✂].[5]

4 https://www.clarusft.com/fx-clearing-2022/

5 [✂]

2.18 Moreover, LCH's market share is expected to increase as ICE has recently announced that ICE Clear Europe will stop clearing credit products in London by 31 March 2023 and will only clear credit derivatives at ICE Clear Credit (in the US).[6]

2.19 On this basis [✂] submits that LCH already has a significant market position in the provision of clearing services for European credit derivatives and in the near future will be the dominant provider.

LCH has the ability to foreclose rival optimisation providers in relation to trades that are not cleared at LCH

2.20 Paragraph 184 of the CMA's Phase 1 Decision notes that: *"the fact that margin optimisation largely relates to uncleared trades, makes any preferential access to data in margin optimisation by itself unlikely to provide LCH with the ability to foreclose"*. [✂] disagrees with the suggestion that a foreclosure strategy in relation to cleared trades could not foreclose rival optimisation providers.

2.21 As a starting point, it is not the case that cleared trades are unimportant for margin optimisation services (despite accounting for less initial margin reduction than uncleared trades):

(a) in order to be successful, it is essential that optimisation providers can access LCH trades, as optimisation is not performed in relation to trades held at a specific CCP, but is rather performed across a customer's trade portfolio. Therefore, any provider that could not provide optimisation services for cleared trades at the predominant CCP would also be foreclosed from the market for cleared trades at other CCPs, as well as for SwapAgent and uncleared trades.

(b) [✂] notes that the total Initial Margin amount for cleared trades in 2021 was $321 billion, which is greater than total Initial Margin amount for uncleared trades ($304 billion).[7] Moreover, as noted above, cleared trades are becoming increasingly important for customers. Therefore, whilst it is correct that today the majority of margin optimisation activity relates to uncleared trades, cleared trades are nonetheless important and will become increasingly important in future.

2.22 [✂] also submits that LCH has the ability to pursue foreclosure strategies in relation to the optimisation of trades that are not cleared at LCH.

2.23 First, LCH SwapAgent offers standardised infrastructure for non-cleared derivatives. If access to SwapAgent were made available to Quantile on more favourable terms, this could place [✂] rivals at a significant disadvantage in relation to trades. SwapAgent has grown rapidly since it launched five years ago and now accounts for a significant proportion of non-cleared derivatives.

2.24 For example, a recent article from Risk.net notes that:[8]

> *"SwapAgent registered over 10,000 trades in 2021, a six-fold year-on-year increase…*
>
> *Participants reckon the platform now accounts for more than a quarter of all cross-currency swap trading. In interdealer euro/US dollar and sterling/US dollar cross-currency swaps, it represents an estimated 40% of activity.*

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6 https://www.theice.com/publicdocs/clear_europe/circulars/C22076.pdf

7 See Clarus Financial technology, 'For the First time, we see over $1TRN in Initial Margin', 25 May 2022, https://www.clarusft.com/for-the-first-time-we-see-over-1trn-in-initial-margin/.

8 https://www.risk.net/derivatives/7949511/a-swapagent-bilat-basis-not-for-now

Some dealers say they put as much as 80% of their cross-currency swaps on the platform, with some even refusing pure bilateral trades"

2.25 Notwithstanding the CMA's comment at paragraph 179 of the Decision that *"SwapAgent would not be able to discriminate as it has no visibility of who creates the trades or if the trades are new or the result of an optimisation run",* this does not preclude LCH from being able to foreclose rivals to Quantile in relation to SwapAgent trades. For example, LCH could in future benefit Quantile through: (i) developing SwapAgent operational procedures that are closely aligned to Quantile's processes and technology; or (ii) enable greater information sharing between SwapAgent and Quantile.

2.26 Secondly, as noted above, in order to be successful in margin and SA-CCR optimisation it is essential that optimisation providers have access to LCH trades. As LCH is dominant across almost all currencies, it will not be possible to provide a meaningful optimisation service in any of those currencies without access to these trades. In other words, an optimisation provider needs the ability to shift exposure between LCH cleared and other cleared trades to provide a meaningful service, e.g. any optimisation in EUR will require the provider to shift exposure between LCH and EUREX.

2.27 For these reasons, LCH's ability to foreclose rivals extends beyond those trades cleared at LCH.

A range of foreclosure strategies are open to LCH

2.28 [✂] considers that there are a range of foreclosure strategies available to LCH that would foreclose rival optimisation providers, including:

(a) providing Quantile, but not rival optimisation providers, with access to LCH's SMART tool;

(b) making data available to Quantile that is not made available to rival optimisation providers or alternatively make data available to Quantile in a more efficient manner and/or on providing Quantile with data on more favourable terms;

(c) delaying new product developments that benefit rivals and/or share details of new developments (as well as take-up of features) with Quantile;

(d) [✂]; and

(e) bundling the provision of clearing services with optimisation services and compression services (as well as other LSEG services), making it difficult for rival optimisation providers to compete.

2.29 Further details on each of these strategies is set out below.

<u>LCH's SMART Tool</u>

2.30 An essential element of margin optimisation is being able to calculate, as precisely as possible, the initial margin a customer has with a CCP. [✂] We understand that Quantile already has access to SMART which enables them to precisely calculate the VaR ensuring accurate calculations rather than an approximation and hence is more efficient.

2.31 [✂]

2.32 However, the potential importance of SMART cannot be understated. Access to SMART would give [✂] a precise estimate of customers' initial margin requirements for their LCH cleared positions and thus increase optimisation efficiency for customers. At the moment, any changes to how LCH calculates initial margin (such as changes to the thresholds or tolerances used in the margin calculation) require [✂]

2.33 Post-merger LCH could make changes to how it calculates margin on a more frequent basis, or make more substantial changes to the initial margin calculation. [✂]. In contrast, and with access to SMART, Quantile would be able to provide customers with efficient IM optimisation outcomes immediately following any changes made by LCH. This would result in customers switching [✂] to Quantile.

2.34 [✂]

2.35 SMART is not only relevant to Rates and FX derivatives but could also offer Quantile an advantage in relation to other asset classes, in particular single name credit default swaps ("**CDS**"). [✂]

Access to other data

2.36 Granting Quantile access to LCH data could provide it with a number of advantages in terms of its optimisation services that would not be available to rival optimisation providers. These include:

(a) LCH could make customer trade data across all asset classes available to Quantile, without making it available to rival optimisation providers. This would allow Quantile to determine which customers would most benefit from optimisation services and specifically target those customers;

(b) LCH could make the same customer data available to all optimisation providers, but grant access to Quantile in a more efficient manner, for example, through access to LCH's full trade representation in Financial Products Mark-up Language (FpML), an industry standard format for derivatives managed by ISDA, which they do not currently allow providers to access;

(c) LCH could make data on clearing available to Quantile. This could include:

(i) early data on changes to clearing patterns that will impact initial margin giving Quantile an advantage in developing new services to align to these industry trends; or

(ii) notifying Quantile in advance of changes to LCH's margin calculation methodology (e.g. information on changes to margin parameters, haircuts or adverse stress scenarios). It would take time for other providers to update their optimisation algorithms to account for these changes, during which time Quantile would be at a significant advantage.

Product developments

2.37 Optimisation is still a nascent market and providers are continuing to innovate and develop new products. In some cases, these product developments require the optimisation provider to discuss the development with clearing houses. For example, [✂]

2.38 This relationship between optimisation provider and clearing house could provide LCH with a range of foreclosure mechanisms, for example:

(a) LCH and Quantile could align their product development cycles so that they Quantile can implement new developments ahead of rivals;

(b) LCH could delay new product developments that benefit rivals; and/or

(c) LCH could share details of new product developments by rivals (as well as take-up of features) with Quantile. This would allow Quantile to launch these developments at the same time as its rivals and thereby eliminate any first mover advantage.

[✂]

2.39 [✂]

2.40 [✂]

2.41 [✂]

<u>Bundling clearing and optimisation services</u>

2.42 Post-merger LCH could choose to bundle the provision of clearing services with optimisation services and compression services (as well as other LSEG services). For example, LCH could offer Quantile optimisation services at a discounted rate to customers that clear a large volume of trades with LCH. This would place rivals to quantile at a significant disadvantage.

2.43 [✂] submits that a bundling strategy could be successful in this case for the following reasons:

(a) by the very nature of the services, all optimisation customers also procure clearing services. This customer overlap creates an opportunity for bundling.

(b) the cost of optimisation services is relatively small compared to clearing services, and LCH could therefore offer a relatively small discount across a bundle of clearing and optimisation services and place rival optimisation providers at a significant disadvantage.

3. LCH WOULD HAVE A CLEAR INCENTIVE TO FORECLOSE RIVAL OPTIMISATION PROVIDERS

3.1 [✂] notes that the CMA did not consider LCH's incentive to foreclose rivals in relation to optimisation services (on the basis that it concluded that LCH did not have the ability to foreclose Quantile's rivals).

3.2 However, for the reasons set out above, [✂] submits that LCH has the clear ability to foreclose rival optimisation providers. Given this, many of the arguments that the CMA considered around incentives to foreclose rivals in relation to compression services equally apply to optimisation services and [✂] submits that LCH has a clear incentive to foreclose optimisation providers for the following reasons:

(a) Quantile competes closely with [✂] in relation to optimisation services and any customers that switch away from [✂] (or other rival optimisation providers) as a result of a foreclosure strategy are very likely to switch to Quantile;

(b) LCH will suffer very limited, if any, loss of sales as a result of any foreclosure strategy. Clearing at LCH is an inevitable reality for the vast majority of customers and there is practically no alternative for customers to switch providers. For example, even with the European Commission actively pursuing a policy to expand CCP activities in the EU, there has been very limited migration from LCH to EU CCPs. This is consistent with the CMA's findings in paragraph 131 to 140, which [✂] considers apply equally in the context of optimisation as well as compression;

(c) the foreclosure strategies outlined above (including preferential access to SMART, access to LCH data, influencing product developments, and introducing approved provider status on unfavourable terms) would not be detectable to LCH's customers and there would therefore be no reputational damage to LCH (or LSEG) from pursuing such strategies;

(d) LSEG's business strategy indicates that it has an incentive to foreclose rivals. In particular, the European Commission's decision in LSEG/Refinitive found that "*the* *transaction would have given to LSEG the ability and incentives to foreclose Tradeweb's rival trading venues and middleware providers*". Acquisition, of Quantile will add compression and optimisation services to LSEG's already wide ranging services (including trading venues, clearing and data) and, as a result, further increase its incentive to engage in foreclosure strategies;[9] and

(e) [✂] recognises that there could be a benefit to LCH from foreclosing rival CCPs if it can grow Quantile into a "must-have" optimisation service and then prevent Quantile from optimising trades at other CCPs. This benefit of foreclosure was identified at paragraph 127 of the CMA's Decision in relation to compression services, but similarly could also increase LCH's incentive to engage in foreclosure in relation to optimisation services.

[9] European Commission, "*Mergers: Commission clears acquisition of Refinitiv by London Stock Exchange Group, subject to conditions*", 13 January 2021, https://ec.europa.eu/commission/presscorner/detail/en/IP_21_103.