Regulation of Securities Trading (MiFID) and The Evolution of Exchanges, Clearing & Settlement

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In this paper the author reflects on two major families of market development and regulatory change, both of which lie at the heart of our capital markets: the creation of an integrated securities trading market through MiFID; and the swift evolution in exchanges and post-trade institutions which set in around the beginning of the new millennium.

I. INTRODUCTION

My purpose in this paper is to reflect on two major families of market development and regulatory change, both of which lie at the heart of our capital markets: the creation of an integrated securities trading market through MiFID; and the swift evolution in exchanges and post-trade institutions which set in around the beginning of the new millennium. In both cases, one is confronted with a fascinating interaction between commercial and market development, the application of various economic ideas and principles and, of course, politics, both regulatory, national and Community.

In the case of *MiFID*, the directive relates at this stage mainly to the regulation of classic trading in equities (i.e., at least until there is action following the review provisions of MiFID's Article 65). The aspects which I consider in the first part of this paper are three:

a) the conflict between the priority given by some to the concentration of all European securities trading "on exchange," via the so-called *concentration rule*; and the increasing tendency, not only in Europe, to permit broker/dealers and exchange-like institutions to "internalize" and match trades—which is sometimes criticized for causing "fragmentation" of market liquidity.
b) the clash between those who would advocate *full price transparency*, both pre- and post-trade, for all exchanges and exchange-like bodies; and those who would argue that it is essential or valuable to give certain special responsibilities and privileges to market-makers (*de facto* or *de jure)* and internalizers because of the services they offer the market.
c) the debate about the *true nature of "best execution"*, in which some advocate that the only test for it is achieving an appropriately low price; as against

those who argue that best execution should provide the best value for money the well-informed client wants, which may involve satisfying other very varied demands as well as considerations of price.

The latter part of the paper considers two aspects of the evolution of exchanges and post-trade infrastructure:

a) how have the *demutualised listed stock exchanges* developed since they were created, and in particular how are they competing; do they provide the services users want; and how far are their inadequacies an international issue?
b) what has been happening to the *post-trade institutions* in the securities' markets, particularly those which are part of a vertically-integrated "silo"?
c) What issues and problems arise from the sector's new fashion for mergers and takeovers?

II. MiFID

Concentration vs. Internalisation

The advocates of concentration rules argue that all trades in all listed securities should be transacted on a single exchange. Confining all bids/demand and offers/supply for a given security in one market has several major advantages. In sum, the advocates claim it optimises price formation; minimises trading spreads; maximises liquidity; and of itself almost amounts to a best execution rule. It is self-evident that securing the concentration of trading in or near one place is valuable in the early stages of creating a sound market when communications are slow, poor or non-existent; and it is notable that the first Investment Services Directive (ISD1) in 1992 provided for such concentration rules to be imposed in those EU countries which wished to do so.

Internalisation arises increasingly as markets become bigger and more complex; and more capital, and more complex transactional procedures and systems, are needed to undertake the increasingly sophisticated trades which buyers and sellers want and modern information technology makes possible. In such circumstances, broker-dealers act not merely as principals, providing liquidity to investors, but they also aggregate, match and net-off buy and sell orders; transact the remaining net orders on exchanges, for example in the manner of the "Retail Service Providers" in the United Kingdom; and also offer a variety of services to customers, such as programme, algorithmic and other electronic trading. Are the advocates of concentration rules right to criticize markets which tolerate or encourage internalisation for permitting "fragmentation" and thereby damaging spreads, liquidity and the rest? (1)

The criticism that trading arrangements such as internalisation create harmful fragmentation is telling when one is dealing with a conventional physical marketplace without any electronic communications, and which is probably subject to ineffectual regulation. But it loses its force in today's circumstances. (2) An effective "Best Execution" rule, combined with post-trade transparency and the communications systems needed to assure it, will in effect integrate a marketplace, even if the participants are spread over a vast area and most are physically separated from one another. Provided internalisers trade their net positions "on exchange," which they will typically have to do, and provided there are a reasonable number of broker-dealers, then arbitrage and market forces will ensure that there is in effect an integrated pool of liquidity.

Moreover, rigorous analysis suggests that for concentration to be helpful, very restrictive conditions must apply, such as are detailed in the section on price transparency below, conditions which assume away the everyday realities of shocks and volatility, the very challenges to which modern markets have been devising effective solutions through such means as internalisation!

Internalisation has a number of important advantages. In particular it:

a) reduces the needs for regulatory capital and systems risks, and cuts transaction costs;
b) increases and improves access to trading;
c) attracts varied providers of liquidity to a marketplace and thereby deepens it;
d) stimulates competition, innovation and a variety of services; and it
e) makes possible trading strategies which are often impossible in classic "auction" marketplaces, for example through a Central Limit Order Book (CLOB). Particularly important is the scope internalisation creates for such procedures as programme trading, market-neutral trading, "buy-write," and large block trades.

In circumstances when much of the market wishes to have these extra facilities, forcing exchanges to continue to operate through restrictive concentration procedures which complicate, constrain or eliminate many of them, is self-evidently very damaging both to the exchanges and the economies which they serve. Marketplaces and economies which have to labour under this burden will be forced to restrict themselves to a narrower range of higher cost trading procedures; and both buyers and sellers will increasingly divert their business elsewhere, which should of course be increasingly easy to do as the European marketplace becomes more integrated.

Full Price Transparency, Post- and Pre-trade vs. Restricted Price Transparency for Internalisers and Marketmakers

Closely associated with the debate about fragmentation and internalisation is an important dispute about price transparency. The essence of price transparency is to be found intuitively in one of the basic principles of perfect competition ("perfect knowledge"), which in this context expresses itself in a belief that all participants in the market should have full information, including guidance as to the various combinations of price and quantity at which buyers and sellers are willing to trade. It is believed that the only way of providing the optimal conditions in which to trade is by ensuring this accurate information about demand and supply is generally available. In such conditions, the market itself will deliver best execution and a "level playing field" for all classes of investor.

In the real world, both analysis and practice show that these intuitively attractive ideas are misleading. Full disclosure of each buyer and seller's supply and demand curve will only improve price information in vigorous, liquid, two-way markets. Insistence on disclosure may discourage people from coming to a marketplace at all, particularly when the participants (on either or both sides) are of different size, or demand and supply conditions are volatile and erratic. Insistence on pre-trade transparency does not make any material difference to best execution, which in any case will normally be achieved by post-trade transparency and arbitrage. In addition, pre-trade transparency typically constrains market participants to a narrow criterion of best execution restricted to best price. Finally, and by no means last, insisting on pre-trade transparency undermines the economics of trading as a principal, with all the virtues that it brings: providing liquidity, making markets, smoothing volatility and the rest. There is little consolation in having a level playing field if it is only a very small one with no (de facto) market makers or providers of liquidity; and if many of the securities which one might wish to trade are not listed, or do not retain an exchange listing for any length of time.

Best Execution as Best Price vs. Best Execution as What the Client Wants

Looking beneath the surface, it is not hard to see that the enthusiasts for the concentration rule and pre-trade transparency have many common features. In both cases, the advocates assume or believe that the authorities can correctly claim to know what the client does or should want. Above all, for them

$$\textit{Best Execution} \equiv \text{“}\textit{Best}\text{” } \textit{price}$$

In order words the *sole argument in any users' utility function is price;* and utility is maximised by the lowest price. Yet both theory and experience indicate that best execution is a function of many variables. In this, as in any other market in which final demand is satisfied, the consumer is sovereign and knows best, except in pathological circumstances. He or she should be free to search or bargain for the best non-price terms and conditions as he or she sees them; and to pay appropriate fees for certainty or speed of transaction, the adoption of buy or sell strategies of a complex kind and so on. And the suppliers should be equally free to compete, innovate and differentiate their service to meet the varied and varying demands of buyers and sellers.

MiFID Controversies: Three Possible Interpretations

What are these three controversies really about? As the arguments came out in the open in the consultations undertaken by the European Commission's DG Market which followed the adoption of the Lamfalussy reforms, it became clear that there were two different market models underlying the economics of these debates.

On the one hand, there were those who believed in the auction model, order-driven, probably implemented through a CLOB. That is very close intuitively to the archetypal concept of a market that economics students learn in their early days. It is easy to see that people instinctively trust the idea of replicating for all goods and services something like the physical marketplace with which everyone is familiar, be it for agricultural produce or traditional commodities, in which all the many buyers and sellers congregate in one place and an auctioneer holds the ring.

On the other hand there is the quote-driven model which plays such a central role today in the more sophisticated financial marketplaces, providing generous liquidity, resilience in the face of volatility, and making possible trading in an enormous range of securities, including the most illiquid. Nonetheless, critics of the quote-driven model often take it as axiomatic that their conception of the classic auction is the best and indeed only reliable and "fair" way of trading . . . .

At a philosophical level, one can see the argument as driven by two very different philosophies. On the one hand there is a Napoleonic, top-down concept of political economy and of institution-building, in which markets, like everything else, have to be constructed by the authorities and only function with rules which conform to the conceptions which those authorities think appropriate. On the other hand there is the classic Anglo-Saxon concept, rooted in the political economy of a pluralistic, decentralised society and economy, in which people interact and trade in a variety of ways to their mutual advantage and devise various kinds of markets in order to do so. (3). From time to time, market participants find it advantageous to empower the authorities to impose certain basic, but limited rules on their markets. But, for the most part, they rely on the normal general legal framework. One of the key features of that Anglo-Saxon view is that the interests and needs of users and consumers are, or should be, paramount.

A third interpretation of what is happening is much simpler, and is straightforwardly commercial. What we have seen in Europe in the debate about MiFID is much more than a discussion of trading procedures and their regulation. It is the defence by exchanges and some traditional trading intermediaries of established monopolies and franchises, which they fear will be eroded by the reformers, and which are already fading. Some of them will be all too aware of the enormous fixed commissions brokers earned on securities trading in U.K. markets before Big Bang in 1986, as against the very small margins which are to be found in the U.K. today, or in other competitive financial markets such as those of the United States. When businesses and their governments mobilise to protect their livelihood, it is not surprising if they use any arguments which come to hand to defend/support their cases. But defence of monopolistic franchises needs to be seen for what it is by the world at large!

III. EXCHANGES AND POST-TRADE INFRASTRUCTURE: PROGRESS IN RECENT YEARS

As a generalisation, it is fair to say that during the last decade, most major economies have reduced or eliminated—at least formally—the protection of their own national, mutualised monopoly stock exchanges. Where this has not yet happened, there is often an active debate and initiatives to bring such changes about. Several important forces have been at work simultaneously. For example

a) many economies have seen moves to abolish fixed commissions and to force broker-dealers to compete on the price of their trading services, as happened in the U.K. in 1986 through the London Stock Exchange's "Big Bang" initiatives.
b) there have been important phases of competition in cross-border trading. The U.K. pioneered this in Europe with SEAQ International shortly after Big Bang. The large share of European equity trading captured for a time by London provoked a series of major reforms in many large continental exchanges. This was then reinforced, if only up to a point, by ISD1 and, at the end of that decade, by the introduction of the Euro.
c) the obstinate and often obscurantist refusal of some stock exchange establishments to move with the times and to heed the wishes of market users, combined with the very considerable value seen to be locked up in the mutual structure of exchanges, led together to an unstoppable, if somewhat unthinking, movement of demutualisation by the end of the last millennium. The incorporation and listing of exchanges through IPOs on their own markets undoubtedly unleashed a great deal of dynamism, both in leadership and management; and the dominant influence of the old vested interests—the conservative brokers in particular—was, indeed, forever broken.
d) all of this has both reinforced, and been reinforced by, technical progress of many kinds: in trading methods; in telecommunications links; in the analysis, provision and distribution of trading data; in order networking; in technological innovations such as *montage,* and so on.

For a short while market users thought that they had entered a brave new world which would bring unbounded innovation, diversity, competition, choice and much else.

The Reality Since Demutualisation

What has been the reality? Technical progress and investment have proceeded apace. Costs have been falling dramatically, and are set to continue to do so, reinforced by the continued vigorous expansion of equity markets worldwide, despite various setbacks such as the Russian crisis in the last '90s or the telecoms crisis early in the new millennium. On the other hand, tariff structures have not moved down in line with falling costs.

There have been sporadic or episodic initiatives to offer alternative equity trading services in competition with incumbent exchanges, including some across the national boundaries; but most exchanges have either concentrated on their own marketplaces or, most frequently, expanded across national boundaries by acquisition of and consolidation with other exchanges, rather than by competition. The active players have been extending control and expanding shareholder and monopoly power**,** rather than engaging in keener head-to-head competition—as many had hoped and expected (perhaps naively) they would do once demutualised.

Exchanges: Costs and Tariffs Since Demutualisation (2001)

The general pattern of falling costs and static or rising charges and tariffs, which has characterised all the major exchanges, is very well illustrated in Deutsche Börse's annual report from 2002 (page 25). Costs per contract fell by 70% in its Eurex subsidiary; and costs per trade in equities on Xetra fell by over 80%, in each case over the 5 years to 1992. All major exchanges have benefited from such gains and continue to do so.

It did not take the broker-dealer community much time after demutualisation to notice that the exchanges were passing on little if any of the benefits of improved technology, higher investment, rising volume and a buoyant external marketplace. Both in London and elsewhere, the major securities associations therefore engaged in much active analysis and review of exchange tariffs. Their broker/dealer members, similarly, engaged in a much more active dialogue with exchange managements. While this may have brought them modest but useful dividends for the first two or three years of this millennium, as a rule there was little fundamental change in the underlying behaviour of the exchanges. The securities associations and their members swiftly drew several extremely important conclusions:

a) first, there was a very distinct possibility that, to varying degrees, some exchanges were abusing their dominant positions. Certainly this is suggested by such developments as the extraordinary increase in their market capitalisations and the very large "special dividends" which they were paying to their shareholders.
b) the broker-dealer community and their clients, particularly the major institutional investors, were able to see that there was a serious, systematic reluctance on the part of exchange managements to pay real attention to user requirements and interests. The exchanges themselves were having recourse to "divide and rule" procedures for dealing with their principal broker/dealers; and were stressing, not entirely unreasonably, that they were profit-maximising companies whose obligations post-demutualisation were to their shareholders alone, not to market users.

c) securities associations, encountering in some cases similar behaviour in post-trading institutions, noted the considerable benefits to market users that had arisen from the conduct of those trading and post-trading institutions which had instituted user-sensitive methods of governance, such as CREST and the London Clearing House. They therefore began to articulate a set of principles designed to maintain appropriately competitive conditions, and to ensure a proper voice for users in the way exchanges were run.

Competition in Equities Trading in Europe in the Last Decade

Competitive challenges to incumbent exchanges in the European equity trading markets in the last decade have not, in the event, amounted to very much; but that is not to say that they are an insignificant consideration. Amongst the more notable initiatives one can record:

Exchanges	*Market*
EASDAQ	Europe
JIWAY	England
Virt-X	Switzerland
DTS (LSE's trading system for Dutch shares)	Netherlands

In addition, shortly after the LSE introduced its DTS for trading in Dutch shares, there was talk in 2005–6 of Euronext offering a degree of competition to LSE trading in U.K. shares. With the modest exception of Virt-X, none of these initiatives has, in the event, led to any sustained and established competitor to the incumbent exchanges, and most have been abandoned. One may therefore characterise such initiatives as intermittent and episodic as a rule. It is clear that there are powerful forces which prevent even the biggest exchanges from contemplating invading other major exchanges head on in major markets of comparable importance to their own. It is important to explore why this is so.

One obvious answer is that it is not easy to challenge an incumbent oligopolist or monopolist at the best of times. It is particularly hard to do so when the competitive process tends to lead to black and white "all or nothing" solutions, in which one party or the other succeeds triumphantly and cleans up more or less all the market for itself, while the other fails so totally that it has to withdraw and close down its operation there. However in the case of securities trading, there are other important factors, which were very clearly underlined by the U.K. Competition Commission's (UKCC) verdict on the possible LSE mergers in 2005. (4) The UKCC made it clear that there would inevitably be little horizontal exchange competition between an established exchange and a new entrant when the challenging exchange could not obtain easy access to the incumbent exchange's clearing and post-trade organisations, which was essential if customers were to be happy to switch their business from the incumbent exchange to the new entrant.

Significantly this possibility was on offer when the LSE made its attack on the Dutch market place with the Eurosets service for trading the most liquid Dutch equities in 2004, with the London Clearing House offering the relevant service. However, it is not something which can generally be relied on. For this reason, the Competition Commission required that any bidder for the London Stock Exchange should forswear vertical integration between its exchange activities and its clearing activities if it should wish to take over the LSE. While this requirement or remedy was one that was not particularly difficult for Euronext to consider accepting, since it was already committed to running down its still substantial shareholding in the London Clearing House, such a remedy was a direct challenge to the vertical integration of the Deutsche Börse group.

The Real Strategic Priority for Most European Exchanges: Consolidation by Acquisition and Merger While the Going is Good

While the propensity of European exchanges to indulge in head-to-head competition in equities trading with their opposite numbers in other European national markets has turned out to be disappointingly modest, their interest in entering such markets by corporate actions has been dramatic. The earliest and most striking example is probably the formation of the Euronext group between 1999 and 2002 by the mergers of the stock exchanges of Belgium, France, Portugal and the Netherlands, and by the acquisition of the U.K. derivatives exchange, LIFFE. As this process was drawing to its close, the newly demutualised Deutsche Börse made its first serious move to merge with the LSE in 2001, which attracted a counter-bid from the Swedish Exchange OM. Neither succeeded then; but Deutsche Börse bid again for LSE in 2005, drawing in competing proposals from Euronext, Macquarie (the Australian financial conglomerate), NASDAQ as well as significant expressions of interest from elsewhere. 2005 also saw the merger between the exchanges of Vienna and Budapest. What has been driving this furious process forward?

The outlines of an answer can be built from the following elements. First, the market capitalisation of the three major European exchanges—Deutsche Börse, Euronext and the LSE—trebled between 2001 and 2006. In 2005/6 alone, special dividends approaching Euros 4.5 billion were paid out by those three groups. Broadly speaking, it is reasonable to suggest that each exchange management can see that they have a significant, if not indefinite, period of substantial monopoly power open to further exploitation, as do their neighbours. In the next few years, there is also open to them the significant possibility of exploiting increasing standardisation of rules and systems as the European market integrates. Therefore the scope for reaping substantial economies on the cost side, while maintaining relatively high tariffs—and hence the scope for not just maintaining but increasing their margins for a substantial period ahead—must be very attractive. In such circumstances, nothing is more logical than to acquire exchanges in neighbouring economies with which a significant degree of synergy and economies of scale and standardisation can be exploited, while exposed to little pressure to reduce charges to users. This will obviously be very good news for the exchange shareholders. But, by the same token, it is very bad news for exchange users of all kinds. Since the regulation of stock exchanges focuses essentially on trading practices and conduct of business, but *not* on maintaining competitive conditions, the exchange managements are not to be blamed for pursuing this strategy. They are simply doing their best to maximise their profits for themselves and their shareholders.

Exchanges are, however, important institutions, whose relatively small size (however measured) is no indication of the great strategic sensitivity of the services they provide, and of their significance as the apex, keystone or fulcrum of the capital market. So the entrenchment, let alone intensification, of a substantial degree of monopoly in such a sector clearly conflicts with the interests not just of market users, but of the capital markets, investors and the economy as a whole.

Post-trade Infrastructures and Ownership in Europe: A Mixed Picture

The reaction both of the marketplace and the authorities to such developments in exchanges and post-trade infrastructures following demutualisation will not be simple or uniform, given the wide variety of exchange and post-trading organisations and structures in the European area. Thus we can see

a) vertically integrated silos in Germany, Italy and Spain, in which exchange trading, clearing and, to a degree, downstream post-trade services are closely linked in common ownership.
b) a significant degree of horizontal separation between exchange trading, clearing & settlement, in Belgium, France, The Netherlands, Scandinavia and the U.K.
c) a significant measure of user ownership and governance in post-trade institutions such as the London Clearing House and Euroclear.

Comprehensive generalisations about the origins of these institutions and the consequences for consumers are hard to make. However in broad terms it is safe to say that, whatever else, all-in "front-to-back" trading costs in Europe compare very unfavourably with those in the U.S.A.

Post-trade Institutions: The Moment of Truth

These high costs have concerned broker-dealers, investment banks and securities houses in Europe for a good many years, as much in clearing as in exchange trading. One early response was in 1999 when the European Securities Forum (ESF) was created by a substantial group of major investment banks in order to create a challenge to the incumbents in the clearing sector. In its earlier phases, the ESF warned that its members were prepared to construct a new entrant from scratch if the existing post-trade institutions did not mend their ways. Another response, in which the London Investment Banking Association (LIBA) and, increasingly, other European Securities associations involved themselves from 2001 onwards, was supporting their members when they challenged the post-trade organisations' high tariffs, as they did those of the exchanges.

In the years that followed, many of the banks and broker-dealers involved in the ESF and the exchange tariff exercises found themselves in a series of sustained and increasingly ineffectual conversations and formal dialogues both with the stock exchanges and with the post-trade institutions where most of their business was done. Before long, it became clear that this process had probably extracted all the beneficial results that were available, at least for the time being. A number of changes of course were contemplated by market users, and some were pursued.

On the one hand, the serious possibility arose of encouraging competition policy actions by inviting formal investigations by the competition authorities into abuse of dominant position by exchanges and post-trading institutions. Another possibility, complementing a successful competition policy initiative to persuade the U.K. authorities to investigate and impose conditions favouring competition on the possible LSE bids in 2005–6 by Deutsche Börse and Euronext, was pursued vigorously by the securities associations in the U.K., France, Italy, Sweden and Belgium. This led to the publication in February 2005 of a fully worked out set of proposals embracing the objectives and principles which should be applied in any corporate action involving exchanges or post-trade infrastructure. (5) These principles emphasised a number of very different but complementary points: the importance of responding to user concerns; of sharing the benefits of productivity growth with the market; of separating the different layers of trading and post-trading so that they allowed fair competition, with no threat of "tying" or "bundling". The contingent fact that some of the most important players in securities trading were proposing mergers or takeovers offered a unique opportunity to urge the competition authorities to call for the adoption of remedies reflecting the combined associations' principles, as part of the conditions for allowing a given merger to proceed.

At the same time, the European Commission's DG Market and DG Competition were well aware of the importance of seeing progress in the reduction of costs in securities trading and post-trading as part of the general programme for strengthening and integrating European securities markets. In September 2005 this led Commissioner McGreevy to initiate a major call for action on the part of the industry, coupled with a warning that if the industry was not in a position to institute effective reforms itself, the Commission would, with great reluctance, have to do the job instead. After a series of further public statements and exchanges involving both the securities associations (6) and Commissioners McGreevy and Kroes in February 2006, agreement was finally reached in the summer of 2006 to pursue a code of practice on a voluntary basis, which would embrace both Europe's major post-trading bodies and market users.

Post-trade Infrastructure: The Close Parallels with the Telecoms Sector

The injection of competition policy thinking and principles into securities trading was innovative by the standards of this very cloistered, inward-looking and self-satisfied sector. But it was not truly innovative. It is important, and very striking, that the structure and economics of securities trading shares a number of important features with the telecoms sector. In that sector, European policy requires the industry to respect nearly all the conditions sought by market users in the exchanges and post-trading area. But it does so by a family of directives and other measures, which were under active consideration in the 1990s and were implemented at the start of the millennium when debates about the competition aspects of security trading had scarcely begun. (7) At the heart of this regulatory structure are

- Common Standards
- Open access and non-discrimination
- Separation of functions, and of their acccount
- Transparency of costs and prices
- Regulation, including of costs and prices
- Protection of consumer/user interests

These are achieved through one regulation (2000), five directives (all 2002), one guideline (2002), one notice (2003) and one recommendation (2003).

Why, one must therefore ask, has such a comprehensive apparatus of regulation been developed for telecommunications, while scarcely any such measures have been discussed—let alone imposed by law or regulation—on the exchanges and post-trading arena? One answer is, obviously, that the privatisation of telecoms began long ago in the 1980s; and the sector is, in addition, enormous. A second reason, perhaps equally important and telling in its way, is that the telecoms sector had to be privatised by a series of laws, and the previous state-run industry was in effect heavily regulated. These circumstances demanded a conscious decision from the policy makers about how to legislate to continue to ensure protection of the consumer interest and how to introduce progressively competitive conditions once a state-run monopoly moved into the private sector.

Looking back on what happened as the stock exchanges of Europe became demutualised, in effect privatised, it is striking how rarely policy makers and security market users saw the parallel with telecoms and, even more, how almost no major proposals or agitation for the imposition of user-oriented regulation were put forward. Perhaps the most likely reason is that many people expected that the original user members of the old exchanges would retain their shares in the exchanges and continue to direct their actions after demutualisation in such a way that the users were not grossly exploited. This expectation was, however, unrealistic. In almost every privatised institution, the shareholdings tends to revert fairly quickly to the norm for the sector and country, and this has certainly happened with the exchanges. Following demutualisation, user shareholdings and user voices in the exchanges' governance therefore shrank to trivial levels very quickly.

Some of the lessons from the telecoms sector can be implemented relatively easily through measures such as a code of conduct being developed following the initiatives of Commissioners McGreevy and Kroes. If successful, these should also make for more competitive conditions in cash equity trading on the stock exchanges themselves, by making it possible for competing exchanges to gain access to the relevant clearing organisations as required without discrimination. But is that enough?

What is Next for the Stock Exchanges Themselves?

The EU initiatives for post-trading do not provide any direct or fully satisfactory answers to the uncompetitive conditions in cash equity trading on the stock exchanges. The implementation of MiFID, the end of concentration rules and the progressive development of internalisation and electronic trading systems will all represent a cumulative increase in the competitive pressure on any given exchange. However, it will nonetheless be rational for the exchanges to continue to pursue their policy of mergers or takeover—in other words of enlarging and consolidating their monopolies—for as long as they possibly can. In addition, the arrival on the European scene of the big American exchanges, NYSE and NASDAQ, and the mergers in contemplation in Chicago, all suggest that there could well be a dramatic and hectic end game of attempted global mergers and takeovers in years to come. If that is so and some succeed, we are faced with an interesting race. On the one hand, the EU Code of Conduct for Clearing & Settlement, technical change, MiFID, liberalisation and the threat of the new European exchange promised by Project Turquoise will be strengthening the pressures for the development of a diversified and competitive series of equity trading and post-trading institutions. On the other hand, users will at the same time face the growing dominance of a shrinking number of increasingly large entities, any one of which could well assume the competitive significance in securities trading of News Corporation, IBM or even Microsoft in their world markets today. One must then ask oneself how the other major players are reacting to such developments.

Users: Effective Promotion of User Governance?

For the broker-dealers and others involved in the successive statements of the European industry such as the 3 February 2005 Declaration of Principles (5), the response to the Declaration's weighty plea for giving effect to user interest in the governance of exchanges and post-trade organisations has been on the whole very disappointing. Even in the U.K., the competition authorities have not discussed, let alone envisaged, the role of user governance as a possible remedy to uncompetitive behaviour. Most exchanges themselves are not keen to make unilaterally the necessary changes to their Memorandum & Articles of Association, their corporate governance or, as important as anything, to reduce their prices as their costs fall, save when in any case under acute competitive pressure to do so. For their part, financial regulators such as the UK's FSA feel that user governance runs the risk of aggravating conflicts of interest about which they are, for other reasons, uneasy.

The securities regulators individually have little direct voice in the terms on which most stock exchanges and infrastructure bodies privatise themselves—though interestingly IOSCO is now interesting itself in these matters. (8) This leaves the biggest question mark over the reaction of the competition authorities, both nationally and internationally.

Unresolved Problems in Exchange Mergers: Possible Deficiencies in the Competition Policy Framework—Particularly at the International Level

Developments in the exchange and post-trading sector have been a very instructive test of the competition policy frameworks both of individual EU members, of the Community as an institution and, latterly, of the global marketplace itself. A number of important conclusions suggest themselves.

At the national level, the U.K. has come out well, with the Office of Fair Trading and the Competition Commission both responding intelligently and vigorously to the merger bids in prospect, particularly the LSE bids in 2005/6. However even there, the criteria which they had to use in a strictly U.K. context were perhaps rather too parochial to match the very real threat of the intensification of an international monopoly structure by cross-border mergers. The scope for *bilateral collaboration* between the competition authorities in major economies, whether within the EU or outside, is clearly minimal as yet, even if there are important international collaborative frameworks which are trying to bring national competition authorities together, at least to harmonise rules and procedures. A particular weakness in the national framework, at least in some countries, is that if the market is already monopolised, the fact that it is going to become more decidedly so if a merger proceeds is not taken as threatening a significant lessening of competition. It is not, therefore, deemed to be worthy of investigation, let alone the imposition of a preventative remedy.

At the *European level***,** the present regime for merger control has proved to be unsatisfactory in several ways in the cases of the exchange mergers. First, the criteria for mandatory review have appeared too mechanistic. The turnover tests applied by DG Competition under the present Takeover Directive do not reflect "strategic" consideration satisfactorily, equating significance with pure size—which may be quite inappropriate with small institutions of major sensitivity, such as stock exchanges. Second, the alternative way of initiating a European review of the merger proposal, which depends on the initiative of individual states via Article 22 of the Takeover Directive, is probably of only restricted and occasional use—and invoking it requires considerable political courage which is often not in plentiful supply, however vigorous may be the voice of user interests.

IV. CONCLUSION

So we are left, then, with the final question as to whether there is any other kind of wider set of principles or institutions which can bring a market- and user-sensitive approach to bear on the possibly undesirable aspects of major cross-border mergers in the exchanges and related post-trade institutions.

This is, of course, an issue which will arise in many more sectors as globalisation proceeds. As of now, there is no sign whatever of any such institution or procedure. The criteria which seemed to be deployed in the recent regulatory debate between major countries about proposed exchange mergers appear to relate to conduct of business, prudential considerations and the rest; but scarcely, if at all, to the maintenance of competitive conditions or to satisfying user interests. It may be that in the very long run this will not matter very much in the case of exchanges, provided the two or three large monopolies which might well emerge from such mergers invite effective competition which will undermine their monopolies before very long. However, no-one can be confident that this will happen for a substantial period of time, if at all; and the damage and costs to the markets may be serious, possibly for a long time.

The cynic may well respond that such a comment is implicitly a call for a highly centralised and integrated world competition authority. The realist should reply that an effective, if not perfect, answer can probably be advised *ad hoc*, at least between the EU, North America and other major players. If we did it for capital adequacy with the Cooke proposals, can we not do it for securities trading?

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VI. NOTES ON CONTRIBUTOR

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