

ADBIOECD Tokyo Roundtable 10/2006

Competition & Integration of Exchanges: Regulatory Implications

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Exchange Competition/Integration – Regulatory Implications

Overview

- 1) Competition
 - 2) Integration
 - 3) Legal and Regulatory Responses
 - 4) Real World
 - 5) The Answer
 - 6) Conclusions
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Exchange Competition/Integration – Regulatory Implications

1) Competition

Competition

Key Effects of Automation on Exchanges

- Marginal Cost of Extra Execution is Zero
 - Marginal Cost of More Info Dissemination is Zero
 - Marginal Cost of Adding Assets to a System is Zero
 - **Economies of Scale are Shrinking**
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Competition

Other Factors affecting Exchange Industry Structure

- Internalization
 - Different Trading Preferences
 - Disintermediation
 - **Network Externality - Order Flow attracts Order Flow**
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Competition

Key Factors affecting CCP and CSD Industry Structure

- Network Externalities for CCPs:
 - Netting
 - Collateral Optimization
 - Benefits to an Exchange of Vertical Integration
 - Legacy of National CSD Monopolies
 - Multitude of Barriers to Competition
 - **CSDs Diversifying up the Value Chain**
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Exchange Competition/Integration – Regulatory Implications

2) Integration

Integration

Potential Cost Savings

- Economies of Scale
- Better Risk Management
- Greater Liquidity by Pooling Order Flow
- Lower User Costs:

Easier Access to More Markets
Common Technology
Common Standards
Common Regulation

Integration

Different Contractual Procedures Possible for Linkages

- Joint Venture
 - One Exchange Purchases from Other Exchange
 - Third-Party Provision
 - **Alternative Business Relationships**
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Integration

Most Linkages Have Failed

- Over-Optimistic IT Assumptions – Cost & Speed
 - Exchange Governance Implications
 - Lack of Credibility of Contractual Commitments
 - Cross-Jurisdictional Legal Issues
 - **Politics**
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Integration

M&A: Lessons

- Anticipated Technological Efficiencies take Time
 - Regulatory Efficiencies Difficult to Achieve
 - Elimination of National Identities Hard
 - **Politics of Mergers Critical**
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Exchange Competition/Integration – Regulatory Implications

3) Legal and Regulatory Responses

Legal and Regulatory Responses

Five Strategies

- Information Sharing
 - Harmonisation
 - Mutual Reliance
 - Mutual Recognition and Home Country Control
 - **Lead Regulator**
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Legal and Regulatory Responses

Harmonisation - Benefits

- Reduce Duplication of Regulatory Effort
 - Ensure Minimum Regulatory Standards
 - **Simplify Market Participant Compliance**
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Legal and Regulatory Responses

Harmonisation - Costs

- Difficult and Slow to Achieve Consensus
 - Compliance with Multiple Regulatory Regimes Still Required
 - Reduces Competition between Rules
 - **Protectionism**
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Legal and Regulatory Responses

The Epidemic of Protectionism - The EU Example

- Vested Interests Capture the Legislative Process
 - Anti-Competitive Laws are Passed
 - Even if Good Laws are Passed, they are not Implemented
 - **Even if Implemented, they are not Enforced**
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Legal and Regulatory Responses

Mutual Recognition and Home Country Control - Benefits

- Eliminates Need for Multiple Regulatory Compliance
 - Competition between Rules
 - Competition between Market Participants
 - **Simplify Market Participant Compliance Obligations**
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Legal and Regulatory Responses

Mutual Recognition and Home Country Control - Costs

- Extremely Difficult to Give Up Sovereignty
 - Potential “Race to the Bottom” – But Not Occurred
 - **Competition will Lead to Some Losers**
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Exchange Competition/Integration – Regulatory Implications

4) Real World

Real World

LCH.Clearnet Merger

- Group, Ltd and SA
 - Ltd and SA respond to Different Regulators
 - **No Single CCP is Possible**
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Real World

Euronext-NYSE Proposed Merger

- Euronext: Worried about LSE
 - Euronext: Fearful of Deutsche Börse
 - Euronext: Far Away means Here to Stay
 - NYSE: Domestic Growth Limited
 - NYSE: Escape SarbOx
 - **NYSE: Diversification – Derivatives & LIFFE**
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Real World

France: Informal Regulatory Conditions for Euronext Merger

- Federal Governance Structure to Remain
 - French Marketplace to Continue
 - **Continued Jurisdiction of AMF**
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Real World

US: SEC Fact Sheet on Cross-Border Exchange Mergers

- Many Integration Forms: No Mandatory Registration
 - No Mandatory Registration Non-US listed Companies
 - No Automatic US Regulation with Joint Ownership
 - US Registration Exchange/Listed Cos. needs analysis
 - Non-US Exchange under US laws Only if Operating in US
 - **SEC Continued Global Collaboration**
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Real World

UK: Enhanced Powers for FSA re Recognised Exchanges

- Government Interest: "To safeguard the light touch and proportionate regulatory regime that has made London a magnet for international business"
 - New power to veto rule changes proposed by exchanges that would be disproportionate in their impact on the pivotal economic role that exchanges play in UK and EU
 - Outlaw imposition of any rules that might endanger the light touch, risk based regulatory regime underpinning London's success
 - No consequence for nationality of ownership of UK exchanges
Overseas ownership neither easier nor more difficult
Still open to overseas investment
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Real World

Asia

- Great Focus on Development after Asian Crisis:
 - New Technology
 - Demutualisation
 - Derivatives
 - Vertical Integration
 - Many National Regional Centres Proposed
 - Little Substantive Commercial Cooperation
 - **Highly Nationalistic**
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Exchange Competition/Integration – Regulatory Implications

5) The Answer

The Answer

Whose Interests do you Serve?

- Users
 - Owners
 - Members
 - Management
 - Public
 - Investor Protection
 - Fair, Efficient, Transparent
 - Reduction of Systemic Risk
 - Financial Centre
 - National
 - **Regional**
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Exchange Competition/Integration – Regulatory Implications

6) Conclusions

Exchange Competition/Integration – Regulatory Implications

Conclusions

- Most Infrastructure Linkages will Fail
- Mergers Hard to Implement, But Success More Likely
- Collaborative Regulatory Rhetoric is Over-Optimistic
- Politics Key Factor determining Regulatory Response
- **And All Politics is Local**