european securities forum

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WORLD STOCKS AND DERIVATIVES EXCHANGES 5:

Why providers should merge

by Pen Kent and Darren Fox

The European Securities Forum, which groups 24 leading securities market participants, argues its case for streamlining back office functions

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By PEN KENT and DARREN FOX

In their February report, the Wise Men, a panel appointed by the European Commission to investigate regulatory barriers to a unified securities system, said that Europe is disadvantaged by its fragmented capital market.

Governments, regulators, investors and issuers of securities agree, as does the European Securities Forum, which represents the global intermediaries who form the lion's share of the wholesale, cross-border market.

But the next step is to agree on why fragmentation imposes costs and how to remove them. The problem does not seem to be in the diversity of competing trading platforms, whether they are traditional stock exchanges or newer electronic communications networks (ECNs) and alternative trading systems (ATSs).

It is possible that this diversity reduces liquidity but the speed and ease of arbitrage can deal with this, provided that post-trade clearing and settlement is not used to capture transaction flow and keep costs high at the expense of users.

This is exactly what has happened in the past. It continues in some vertical "silos" (operators with more than one service built on top of another), dominated by traditional stock exchanges, which are sometimes able to maintain what are effectively local monopolies. These stand in the way of a genuine pan-European capital market that could be at least as deep and liquid as the capital market in North America.

What Europe needs is a capital market that investors and issuers can access wherever it suits them without distortions of price, regulation, technology or culture. Life in the back offices of Europe fails this miserably.

The European Securities Forum wants the remedy to be provided by the market. The Wise Men agree but go on to say that if the market does not succeed, governments might have to intervene. That would be an indictment of the market's short-termism and inability to implement long-term strategies.

The European Securities Forum proposes:

* to transfer control of clearing and settlement from trading platforms;
* the creation of a pan-European central counterparty, largely owned by users, providing price anonymity and netting for those who want it;
* rationalisation of settlement into fewer institutions.

Could a pan-European stock exchange, brought about by a merger of all the major exchanges, deliver the dream?

There is no doubt this would yield real economies of scale and streamline processes for markets. But as a "mega-silo" it could also suffer all the problems of the current structure, with control dominated by those at the top.

This highlights another problem with the vertical structure. Stock exchanges are demutualising and becoming quoted, profit-maximising companies. Would investors, intermediaries and regulators be happy for the European central counterparty, which manages the clearing and settlement pipeline, with all its risks, to be owned or controlled by a commercial company?

There is a strong argument for clearing, and perhaps settlement, being a natural utility - run for the public good and on a not-for-profit basis. This should not be a monopoly protected by law but one tolerated by law.

There are surely ways of designing a governance that drives down costs, incentivises management and allows sufficient accumulation of reserves to finance improvement and investment. The US faced this issue in the 1970s and concluded that the benefit to investors of a single utility outweighed questions of competition.

The ESF's first choice is for existing service providers to merge. The new owners, the market users, would, of course, have to pay for the assets they acquired, although many of the users would also be selling.

The precise design would depend on many market, regulation and national interests, and may not be perfect. But that would be less important than making the first stride forward and giving the new structure the freedom to evolve over time.

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If this approach cannot work we will have to consider more radical steps. Choose a winner and starve the rest? Ask custodians and broker-dealers to internalise as much as they can? Markets have a knack of finding alternative solutions when the obvious fail. The market wants a breakthrough this year. We are trying to help it get one.

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