




**Special Report**



**Financial exchanges**

# Battle of the bourses

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**Behind the mergers of financial exchanges lies not just a quest for size and scope, but also a fight for survival**

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THE desire to merge has never been stronger among the world's financial exchanges. This week the bidding intensified between the Frankfurt-based Deutsche Börse and the biggest of them all, the New York Stock Exchange (NYSE), to buy Euronext, itself the product of a series of mergers that, if talks go well, may soon absorb Milan's Borsa Italiana.

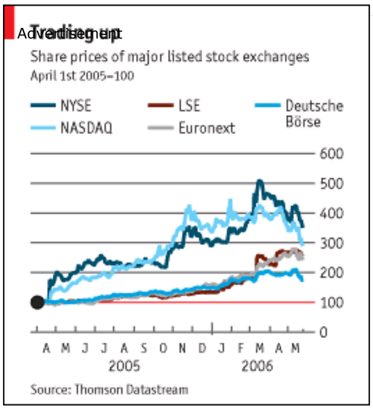
At Euronext's annual shareholder meeting in Amsterdam on May 23rd, Jean-François Théodore, its chief executive, was given a rough ride before eventually winning backing for his choice of partner, the NYSE. This would create the first transatlantic exchange capable of offering equities, options and futures. Many Euronext shareholders would prefer a more local marriage with Deutsche Börse, which is even now said to be preparing to raise its bid to top the American offer of €8 billion ($10 billion) in cash and shares.



Meanwhile, the London Stock Exchange (LSE) is once again the subject of unwelcome attention. Having fended off bids from Deutsche Börse and Macquarie Bank of Australia, the exchange is now stuck with a single suitor and few choices. NASDAQ, which had its previous approach rebuffed in March, has been busy building a 25% stake in the London exchange—enough to thwart, or at least complicate, any rival bid. Nor can NASDAQ quickly tie the knot. Unless the LSE accepts its bid or receives a counter-offer, Britain's takeover rules prevent NASDAQ from either making another bid before October or increasing its stake beyond 29.9%. Still, shareholders cannot complain about the London exchange's *froideur*. Deutsche Börse said it would offer £5.30 ($10) a share, Macquarie bid £5.80 and NASDAQ offered £9.50—and would have to pay still more if it bid now.

Such rises are partly the result of speculation by increasingly powerful hedge funds. But even though share prices of the listed exchanges have come off their record highs (see chart), analysts are still hard pressed to explain why shares in Deutsche Börse, for example, are now worth about €100, up from €45 at the end of 2004.

These high valuations come at a time when the franchises held by exchanges seem ever more vulnerable. They face intensifying competition, fostered by technology that is rivalling the exchanges' traditional trading methods and by regulation that is increasingly permissive (if also still sometimes highly political). Commissions are declining fast and a growing volume of trading in financial securities of all sorts now takes place "off exchange", inside banks or across alternative networks.



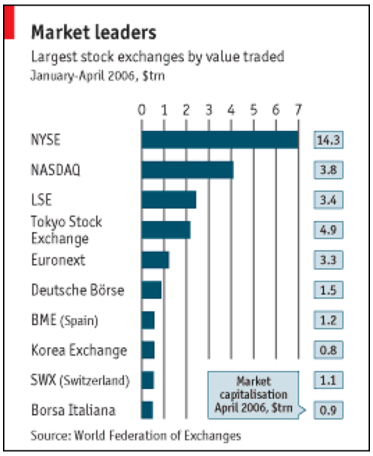

Strikingly, this picture of an industry in a corner is wildly at odds with the exchanges' declared rationale for merging. This is all about the efficiency of the infrastructure behind the world's capital markets. From the exchanges' point of view, today's transatlantic battle is the latest step in an evolution that began in Georgian London's coffee houses and under a New York buttonwood tree.

The hundreds of exchanges, usually housed in grand buildings with spacious trading floors, which grew over the centuries out of those informal gatherings, have no place in today's world of global capital flows and high-speed electronic trading. The old-style exchanges were traditionally organised as mutual trading clubs that charged outsiders commissions and others fees to gain access to their liquidity. Their members mounted a lengthy rearguard action against the forces of efficiency, which promised to benefit their customers at the expense of their own traditional sources of profit. That has now ended in a series of demutualisations. Members have voted to turn their exchanges into for-profit public companies. Now the members have cashed out, the exchange can then be run—or, increasingly, sold—to maximise the value of the business rather than to serve the narrow interests of its members (by providing such benefits as jobs for floor traders, or a privileged look at the order flow from outside investors). The three big European exchanges—LSE, Euronext and Deutsche Börse—demutualised in 2001. The NYSE listed its shares in March.

With outside shareholders now in charge, consolidation of the world's exchanges can take place relatively easily. "The dream of this mating of dinosaurs is to create a global super-exchange that is a natural monopoly," says André Cappon of the CBM Group, a consultancy that specialises in exchanges. "Then they hope to raise prices—though, of course, no one will admit that this is their goal."

Instead, exchange bosses prefer to dwell on the potential cost savings and economies of scale that they expect from integration. The technological demands on exchanges are growing rapidly, especially as hedge funds increasingly dominate trading—they account for about 40% of volume in America, for example. Many hedge funds use automated algorithmic trading methods that spew out vast quantities of electronic limit orders designed to exploit trading opportunities that may exist for only a fraction of a second.

Building a trading platform able to handle this order flow is expensive. But most of these costs are fixed, so big economies of scale can be gained by adding more shares or other financial products to a trading platform. This, it is argued, reinforces a natural tendency to gravitate to a single exchange, as buyers of securities typically feel that they are likely to get the best price if they can deal with as many sellers as possible and vice versa.




The European Commission foresees vast gains from consolidating exchanges within Europe. According to a commission document released on May 23rd, Europe's aggregate extra cost of trading, clearing and settlement (the "paperwork", in pre-electronic jargon) is between €2 billion and €5 billion a year. Eliminating that would lop 7-18% off investors' costs. The commission is particularly exercised by the high cost of cross-border trading. Buying and selling shares in another European Union country can cost up to six times more than dealing at home.

On the face of it, big cost savings would flow from merging Deutsche Börse and Euronext, especially given the "spirit of true partnership" radiating from the German exchange's boss, Reto Francioni. In fact, that is a friendly-sounding way of saying that the merged exchange would be run out of Frankfurt, with Mr Francioni in charge, and the two businesses integrated as much as possible.

### The silos of trading

But it is easy to pick holes in the exchanges' story. For a start, the savings assume that the promised benefits of integration can be secured—which, as in mergers of all sorts, is easier said than done. Euronext's boss, Mr Théodore, can testify to his own frustrations following the acquisition in 2002 of Liffe, the London International Financial Futures and Options Exchange.

One worry is that Deutsche Börse operates a vertically integrated trading "silo" in a way that makes it hard to identify the costs of trading, clearing and settlement. Although Deutsche Börse says it has the cheapest clearing and settlement, no one is entirely sure it is right. The fear—voiced especially loudly by Thierry Breton, the French finance minister—is that a hidden cross-subsidy between different parts of the business may distort competition. A European directive on clearing and settlement is likely to address this worry, but not for at least three years.

American exchanges are not responsible for clearing and settlement, which is one reason why Mr Breton appears to favour the NYSE bid for Euronext—although he has not officially taken sides. But there may be other grubbier reasons behind the

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Indeed, national pride and self-preservation ring as clearly in the exchanges' plans as the opening bell at the NYSE. Mr Théodore's acquisition of Liffe did not deliver the promised economic benefits, but it at least prevented the LSE from buying its domestic partner, a merger that would have created a combined London exchange capable of crushing the Paris, Amsterdam and Brussels exchanges that had together formed Euronext.

Other potential mergers have fallen foul of nationalistic politics, too. A first bid for the LSE by Deutsche Börse in 2000, and the German exchange's approach in 2004 to SWX, a Swiss stock and derivatives exchange group, both collapsed. A cautious eye also has to be kept on the powerful hedge funds. A year ago activist shareholders led by a hedge fund called TCI forced out the then boss of Deutsche Börse, Werner Seifert. The fund believed his bid for the LSE was too expensive, leading one prominent German politician to describe hedge funds as "locusts", even as other commentators praised them for introducing financial discipline into a business that had hitherto not given much thought to its shareholders' interests.

Now TCI and Atticus, another hedge fund with shares in both Deutsche Börse and Euronext, are pressing for a fusion of the two. Political pressures probably rule out any last minute embrace between Deutsche Börse and the LSE—in many ways, the natural European combination—despite rumours that the German exchange is mulling a bid for NASDAQ which would bring with it a 25% stake in its London rival.

Politics and pride also help explain why the New York exchanges want to invest in Europe. John Thain, the boss of the NYSE, is hugely ambitious. He took charge at one of the lowest points in the Big Board's history. Scandals had driven out its former boss, Richard Grasso, the self-styled "CEO of capitalism". Mr Thain's move to the exchange was thought to owe as much to his desire to prove himself worthy of high public office by saving the NYSE as to his frustration at not getting the top job at his former employer, Goldman Sachs. He may have concluded that the American public will think more of him if the NYSE emerges from the dealmaking as one of the consolidators rather than the consolidated, regardless of whether its owners gain most from that strategy.

And although you can take the man out of the investment bank, you cannot seem to take the investment bank out of the man. Mr Thain clearly has a taste for deals. He recently merged the NYSE with Archipelago, an electronic-trading exchange partly owned by Goldman. The deal benefited the investment bank in so many different ways that some Wall Street wags joked how Mr Thain had not left the firm after all. Apparently in part to silence such critics, Mr Thain has chosen Citigroup, not Goldman, as the NYSE's adviser for the Euronext deal.

Another attraction of Euronext to the NYSE is that it caters for trading in both shares and derivatives, something the London exchange cannot offer. One way to maximise the value of a trading platform is to push more transactions through it, and although it is hard to invent new shares to trade, dreaming up new derivatives is a piece of cake.

Above all, through a European merger Mr Thain may hope to regain access to the new-listing business. This is clearly a goal of NASDAQ, too. In 2000 nine out of every ten dollars in the world's initial public offerings were raised in America. Last year nine out of every ten dollars were raised outside America—which Mr Thain bemoaned at a dinner last month with Silicon Valley luminaries. The flight of initial offerings, notably to the LSE's Alternative Investment Market, has been blamed on America's costly Sarbanes-Oxley law, introduced after the collapse of Enron.

One of the biggest fears of investors in London is that if NASDAQ buys the LSE, it will bring with it the dead hand of Sarbanes-Oxley. "Whatever happens, the regulatory domicile must stay in London. Apart from that, we have no particular prejudice who owns the exchange," says Peter Montagnon, of the Association of British Insurers, whose members control about one-sixth of the shares on the LSE. "What makes London attractive is its regulation. One of the things we regulate well is listings." Although regulatory arbitrage may now be its main goal, NASDAQ has a long history of overseas expansion, little of it happy—a lesson worth pondering during today's merger frenzy. In the late 1990s the exchange struggled in both Europe and Japan. (How long before the Tokyo Stock Exchange gets caught up in merger mania, too, assuming its planned flotation goes ahead?)

Thanks to regulatory arbitrage, the exchanges can gain from national regulators' determination to exercise their own market oversight. On the other hand, the exchanges' differing trading rules may limit the scope for efficiencies. Perhaps common trading rules can be developed between regulators in America and Britain, says Benn Steil, a financial economist at the Council on Foreign Relations in New York. But America's Securities and Exchange Commission is "in an exceptionally weak negotiating position, as American investors are increasingly going abroad to invest," he notes.

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In any case, regulators seem determined to prevent a single global trading platform with natural-monopoly power, says Mr Cappon. Indeed, he doubts that such a monopoly could arise even if regulators stood back. A few hedge funds may think they can profitably monopolise the trading infrastructure, but plenty of actors in the financial markets will do all they can to stop that happening.

The power of traditional exchanges is likely to be curbed in three ways. The first is for big financial

**Making good television**

institutions to "internalise" their trades, netting off buy and sell orders against each other without passing them through an exchange. The big Wall Street firms have lately made great efforts to internalise trading through electronic alternative-trading systems, commonly known as ATSs. It is widely expected that these will eventually be linked together directly. The old members of the NYSE, in short, will create their own membership network. This cannot be good for the NYSE, something that will surely not have eluded Mr Thain. In Europe, fears that a pending directive over markets in financial instruments will hinder such internalisation have eased.

Secondly, investors can trade "over the counter" via brokers rather than through an exchange—a business that is booming. The last curb on the big exchanges is a forthcoming wave of technological innovation, which will help America's regional exchanges, such as the Boston Equities Exchange. These only recently seemed doomed, but the Boston exchange is now being revived by Citigroup, Lehman Brothers, CSFB and others.

In America, three firms provide a particularly promising and different way to trade: POSIT, Pipeline and, above all, Liquidnet. Each offers big institutions anonymous ways to trade large blocks of shares, something that has become increasingly difficult when using an exchange in the traditional way. Liquidnet has grown in five years to 45m trades a day, and Pipeline to 20m a day in two years. The three firms now account for some 5% of daily trades in America, and will surely soon be far bigger.

**Playing Monopoly**

So much for the notion that liquidity and technology will inevitably make trading a natural monopoly. NASDAQ's overwhelming market share in stocks not listed on the NYSE and American Stock Exchange disappeared a decade ago. It has never returned, despite the acquisition of its largest competitor, Instinet. Up to two-thirds of transactions in British shares and perhaps 75% of German share trades now take place off-exchange, according to Hans-Joachim Voth, an economist at Barcelona's Pompeu Fabra university.

As the exchanges lose market share, they may not be able to retain the lucrative business that some of them have selling price and trading data. And as liquidity moves away, too, can they also retain their traditional role of price discovery? Mr Steil, for one, is optimistic that even if their share of trades shrinks, not much trading need take place through the exchanges for their prices to be useful indicators of value to off-exchange traders.

It amounts to another evolution from the traditional heart of the old exchanges: the floor on which traders once jostled as they called out their buy and sell orders. These floors have been dying out fast in the past decade, replaced by quieter electronic trading rooms. Mr Cappon reckons, plausibly, that the rest will go within maybe three years, with the possible exception of the famous NYSE trading floor. It might survive, he believes, in token form. It would primarily become a marketing tool, because "it makes such good television".

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