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Plenary 1

Securities Exchange Evolution and the Regulation of Transnational Securities Exchange

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**Securities Exchange Evolution and the Regulation of
Transnational Securities Exchange**

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Ladies and Gentlemen,

It is indeed a great pleasure to be here with you this afternoon and to have the opportunity to moderate this panel on “Securities Exchange Evolution and the Regulation of Transnational Securities Exchange”. This is, for sure, a highly debated topic and we are glad to have with us three knowledgeable panellists whom I

would like to present to you before delivering some introductory remarks.

Ruben Lee is founder and managing director of the Oxford Finance Group, a private research and consulting firm. Ruben is a prominent expert on issues related to market infrastructures.

Jean François Théodore is Chairman and CEO of Euronext, a pan European group of exchanges which is finalising a combination agreement with the NYSE. The new company, NYSE-Euronext was floated a week ago in Paris and New-York.

Hugh Sandeman is head of business development for India at the London Stock Exchange which has, of course, been directly involved in recent international developments and has been wooed, unsuccessfully, up to now, by a number of champions.

Over the last few years, the exchange industry has seen remarkable growth and structural dynamism across the globe and securities markets are all facing similar challenges and are subject to the same drivers for change, if not at the same time and not in the same intensity.

I have identified four main issues which I propose for discussion between our panellists: demutualization, together with privatisation, consolidation, competition, both cross-border and with new trading venues, and finally, changes in the post trade environment. I would like to briefly touch on those key trends and developments and provide some of the background against which both securities exchange and regulators potentially have to reassess their role and responsibilities. For those who have not done so yet, I would also invite you to read the very timely report of the

IOSCO Technical Committee on “Regulatory issues arising from Exchange Evolution” dated October 2006 which provides an in depth analysis, from a regulatory perspective of most of those developments.

Demutualization, together with a public listing of the exchange in many cases, has become of common phenomenon during the past years and a major driver for change. Twenty-six exchanges are publicly listed today (6 in 2000). Over 70% of the world’s market capitalisation resides on publicly listed exchanges, and another 18% on demutualized but non-listed exchanges.

This new business model and the competitive environment in which it operates have inevitably raised questions as to the potential impact of such a change on exchanges’ regulatory role, including the risks to the

maintenance of a proper balance between an exchange's public interest obligations and its commercial interests. The IOSCO Technical Committee addressed this question in the "Issues Paper on Exchange Demutualization" published in June 2001. More recently, the IOSCO Emerging Markets committee prepared a report entitled "Exchange Demutualization in Emerging markets, published in April 2005. That report provides a perspective on how the issues raised by demutualization may vary according to the state of development of a market and the specific environment within which the exchange operates. In its 2006 report, the Technical Committee's notes that most approaches to address the potential conflict between the commercial interests and regulatory obligations of an exchange involve governance arrangements, separation of functions within an exchange, restriction on ownership, oversight

arrangements, transfer or removal of regulatory functions. It also notes that no jurisdiction represented in its SC2 has so far opposed or prevented their exchange from demutualization and converting to for-profit operating, recognising that competition among market operators should offer market users efficiency benefit.

Indeed, the demutualised, for profit, model is becoming a standard and is considered to allow for a more effective response to forces reshaping the exchange business.

However, it seems to raise some concern among former members of mutualised exchanges who, after they have sold their positions, think about the possibility to rebuild new trading venues they would control. It also raises concern among users, and more specifically issuers, who regret the loosening links with the exchanges and sometimes criticise the new governance arrangements.

So my first question to our panellists is: how do you react to these evolutions and how do you respond to these challenges?

The second trend is consolidation in the broad sense of it, including alliances, links etc ... Having turned into for-profit enterprises in many cases, exchanges are required to deliver value to their shareholders and are under increased pressure to make profit, potentially faced with a strong shareholder activism. Expanding business and achieving economies of scales in an increasingly globalized and competitive environment becomes critical for for-profit exchanges. To that end, consolidation has taken or is taking place at national level (NASDAQ/Inet, takeover of the Sydney Futures Exchanges by the Australian Securities exchanges completed in July 2006, NYSE reverse takeover of Archipelago in January 2006,

CME offer and ICE counter offer on CBOT) or cross-border (Euronext, OM, NYSE-Euronext, unsuccessful NASDAQ offer for the LSE...). In expanding business through links, alliances or full corporate mergers, exchanges aim at facilitating access to their markets and increase the distribution of their products, hence their liquidity. They also look for product diversification to find new sources of revenues, with a growing interest for derivatives products and seek to offer side-by-side trading of cash, derivatives and fixed income instruments under one roof. However, it's worth noting here that there seems to be no unanimous views among exchanges as to the best type of strategic move. Cross-border alliance, links, "let's be friend" statements have been flourishing in the press over the past few months, while full corporate mergers remain the exception.

The development of cross-border business raises a considerable challenge for regulators to maintain an appropriate level of regulatory framework while fostering market development. The regulatory issues raised vary, depending on the actual content of such cross-border business which can potentially encompass a wide spectrum, from expansion of remote membership to the creation of cross-border corporate groups. As regards remote membership and the setting up of trading screens in a foreign jurisdiction, a report on multi-jurisdictional information sharing just approved by the Technical Committee provides a useful framework for a better understanding of the regulators' information need in such circumstances. I am also very pleased that, in this area as well, mutual recognition seems to be recognised as a viable and fruitful approach by an increasing number of jurisdictions.

As stressed in the IOSCO 2006 on Regulatory issues arising from Exchange Evolution, the issues raised in each instance of cross-border infrastructure depends on the nature of the corporate structure and the way the group intends to operate its business

As groups come to operate in a more integrated way, [like in the Euronext case], a major challenge for regulators is to ensure that the elements of the group for which they have responsibilities comply with their national regulatory requirements and to find ways to collaborate with other regulators that enable regulation to be conducted effectively, and also efficiently. Hence my second question: how do our panellists foresee the future of consolidation, both from an industrial point of view and from the point of view of regulatory convergence or diversity?

A third trend I would like to mention is the rising domestic and cross-border competition between regulated markets and new trading venues, due to what some would qualify as a “*creative disorder*” a French expression to design a process whereby removing traditional regulatory barriers, while destabilising traditional arrangements, gives way to new initiatives and opportunities expected to deliver a better equilibrium.

In Europe and in the US, two pieces of regulation are under way, or already implemented, that are expected to profoundly affect the respective securities industries. These are MIFID in Europe (the Markets in Financial Instruments Directive) and the SEC’s Regulation NMS in the US. Both follow similar objectives of improving

investor protection and increasing the efficiency and transparency of the markets.

MIFID, which will enter into force on November 1st this year, aims at providing an open and competitive environment for trading. The directive includes pre and post trade transparency as well as best execution requirements in order to mitigate the potential drawbacks for market efficiency resulting from a possible market fragmentation. My third set of questions would then be: will the “stickiness” of liquidity which has so far prevailed in the equity market continue to prevail or will best execution requirements lead to the development of smart order execution systems to the same extent as in the US, with the end result of actually challenging this stickiness? How far shall we see some fragmentation of the markets developing and what consequences will it have on price discovery and market efficiency? How will

regulated exchanges react to this new competition? Is there a risk that supervision of these fragmented markets be hampered and how should regulators react in the interest of market efficiency, market integrity and investor protection?

The last set of issues in securities exchange evolution I would like to address today is linked to the post-trade environment. Clearing and settlement play a key role for the smooth functioning of securities markets. As more and more exchanges are looking for alliances or mergers as a way to grow revenues and increase efficiency, as new competitors enter the market, a question may be raised as to whether the clearing and settlement infrastructures can move at the same pace as the markets. Quite different models and architecture prevail across the globe, including in Europe and in the

US.. The EU Commission promotes competition, transparency of prices and interoperability and linkages among systems as a way of increasing freedom of choice and improving efficiency. Consolidation is an alternative approach with relevant question as to the regulation of such consolidated entities, the transition from multiple for-profit entities into a single non-for profit one and the capacity of such single entity to remain innovative and efficient.

It is up to the public authorities, market participants and the clearing and settlement industry to decide on the road to take to serve multiple trading venues operating cross-border, accommodate new instruments and meet regulatory concerns. This is also a challenge for securities exchanges which have to make strategic choices in an increasingly globalised and competitive marketplace.

Hence my last questions to our panellists: how do you see future developments in that field? What should be the respective roles of public or mutually owned utilities and of for profit entities? What do you think of the ongoing debate on the merits and risks of the so-called silo systems?

Ladies and gentlemen, I feel it is now more than time to turn to our panellists, and I would propose to give the floor to Ruben Lee who will give us the views of a wise man, as he is not directly involved, as an operational market player, in this complex and heated debate.