



CEPS Commentary/ 9 February 2007

## The FSA should not resist takeover of stock exchange

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Europe's bourses feature almost daily in lead articles in the media these days, which is probably excessive given their relatively small size in terms of revenue. If it is not about alliances or takeovers, the coverage concerns their responses to the challenges raised by the recently adopted Markets in Financial Instruments Directive (MiFID) or other forms of ongoing market liberalisation. It should come as no surprise that, in a business where scale matters, responses go beyond European boundaries, and after Euronext, the London Stock Exchange (LSE) may also become a transatlantic exchange. This is a logical evolution given the strategic choice the LSE made some years ago to focus on its core business, i.e. trading.

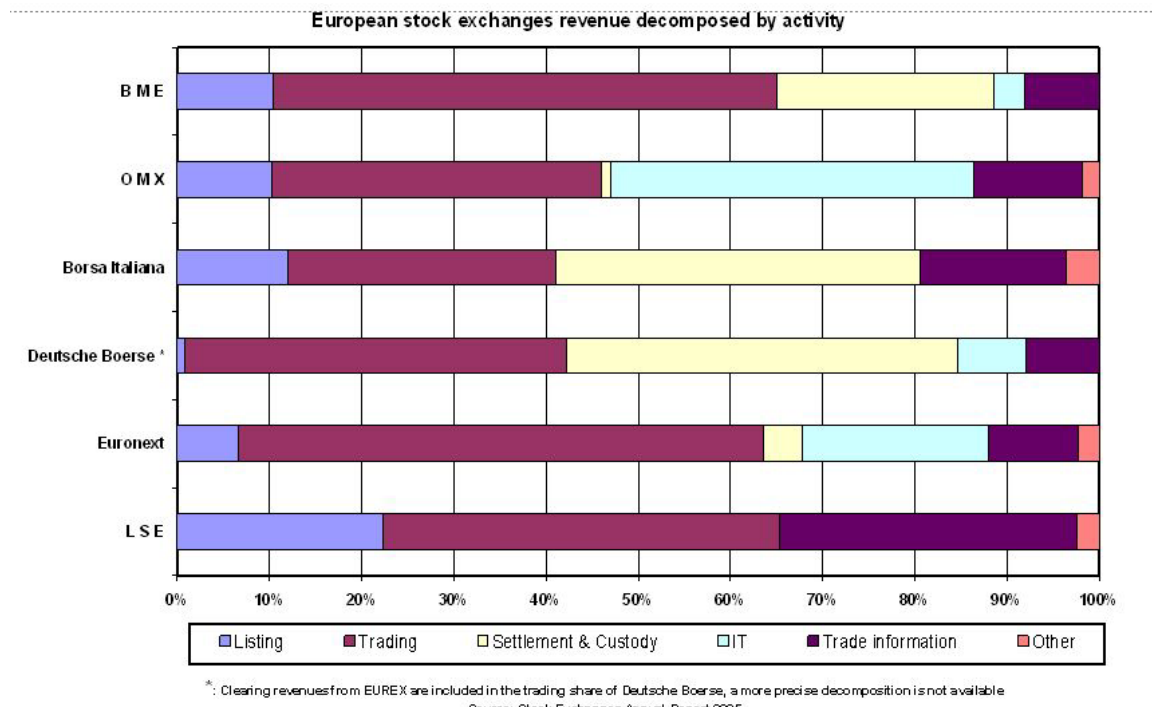
Exchanges' business today is composed of fairly distinct segments: listing and trading, revenues raised from vending market data or providing settlement, and selling IT services. This fairly heterogeneous composition of services originates from a time when exchanges were state monopolies or 'mutuals' owned by banks and brokers. Most European exchanges have in the meantime been privatised and started to adapt to the new context. Some exchanges, such as Euronext and the London Stock Exchange, have chosen to strengthen their core business, trading, whereas others have focused on vertical integration to provide straight-through-processing to clients. The former have thus chosen to provide a single service, trading, at an increasingly global level, whereas the others have opted for a full set of services within a given market.

The coming into force of the Markets in Financial Instruments Directive in November 2007 presents profound challenges for all the exchanges. In a nutshell, MiFID promises to bring more competition to all core businesses of exchanges. The directive abolishes the monopoly of exchanges in trading, and allows banks to internalise, to make internal matching of trades. It no longer requires banks to pass on trade data to the exchanges, but allows them to sell these data to other firms, such as data vendors. It opens up the market for settlement by giving investment firms a free choice of the venue of settlement. In addition, the directive facilitates the creation of new exchanges or multilateral trading facilities (MTFs).

Thus trading revenue, which accounts for about 42% of the income of the six largest EU exchanges (and 57% for the LSE), will come under pressure as a result of more competition from banks and other trading platforms, such as 'Project Turquoise', the initiative by seven investment banks to set up an alternative trading platform. Revenues from data vending, which represent about 12% of the income of the six largest EU exchanges (32% for the LSE), will suffer from more competition from existing data vendors such as Reuters and Bloomberg, or initiatives such as 'Project Boat', a new venture again by investment banks to sell all their trade data to an MTF. Settlement, which provides about 18% of the income of the six largest EU exchanges (LSE has divested settlement), may not be so directly threatened, although also here the market will be opened up. There is also, however, one further initiative looming that may profoundly affect the market, namely the Target 2 Securities project of the European Central Bank.

It is clear that the LSE, with 89% of its revenues stemming from trading and data vending, should be extremely concerned by MiFID. Although the LSE has already been more exposed to a competitive market than the other European exchanges, since internalisation is already possible in the UK, it is more exposed than the other European exchanges to two single sources of revenue, both of which are directly and immediately affected by MiFID. The statement by the NASDAQ's CEO that "MiFID is one of the biggest threats to the London Stock Exchange's business in its 300-year history" is thus no bluff.

In this context, it would be wise if the FSA, and the British establishment, took a less protectionist attitude to the takeover by NASDAQ, just as it should have done to other European takeover attempts, such as those of Deutsche Börse. The only way for an exchange to survive in the post-MiFID era is to increase its scale or scope, which for the LSE, as for Euronext, can best be achieved through integration with the capital market that is the closest to the European one, namely the US. For shareholders, it is clear that, given the current share price, and the developments sketched out above, this is a golden opportunity to sell.



*Karel Lannoo is Chief Executive of CEPS, an edited version of this Commentary was first published in the European Voice, 8-15 February 2007.*