Editorial: Challenges and chances for European exchanges

Introduction

There have been three major developments that characterise the changes in the European Exchange landscape over the past 20 years: the globalisation of financial markets, the revolutionary developments in technology, and European regulation. European Exchanges have reacted to the changes in their environment with, in several cases, drastic steps.

At the end of the year 2000, the Federation of European Securities Exchanges (FESE) counted 22 members, itself a testimony to Europe's variety and diversity on one hand and to the growing internationality of the business on the other. After the political change in the early 1990s, exchanges were established in almost all the emerging economies of Central and Eastern Europe. The FESE's membership extends today to all European Union (EU) member states, to Iceland, Norway and Switzerland, as well as to four EU accession candidate countries: Cyprus, Hungary, Poland and Switzerland. EU legislation has its influence today in all accession candidate countries — the FESE keeps close bonds with the exchanges also in those countries and hopes to receive them as members soon.

Recently, the Federation has opened its doors to the European Futures and Options Markets and intends to welcome derivatives markets as members later this year, thus becoming the voice of *all* regulated securities markets in Europe, especially towards the EU institutions,

but also to the Forum of European Securities Commissions (FESCO), to the OECD, to non-European institutions, and to other sectors of the financial industry.

Globalisation of markets

Supported by the developments in communication and information technology, financial markets have become truly global. Following the trend in the foreign exchange and international bonds sectors, the equities markets themselves have also moved from fairly national affairs to global cross-border operations. It is interesting to note in this context that the market mechanisms of those markets are now in turn starting to follow the equity markets, concentrating more than before on quality aspects such as centrality, transparency etc.

Trends on both sides of the market, supply and demand, have supported this move towards internationalisation. With the creation of larger and larger business units, many of them operating on a multinational scale, their demand for equity capital exceeded the amount of capital any closed economy would be able and willing to provide. More and more international corporations began to raise capital abroad and wanted, in parallel, to provide their investors with wider trading opportunities in their stocks.

This trend was accelerated in the 1990s by the results of widespread privatisation programmes in practically

every European country. These privatisations further increased the amount of investment required and added to the internationalisation of European equity markets. As an additional factor, tightening prudential regulation for banks in Europe reduced the attractiveness of corporate loan finance, notably in those countries where companies tended to rely heavily on debt rather than equity for the financing of their business.

On the demand side for good investments, the increase in volumes was to a large extent driven by the change in investment patterns of wide circles of the European population. Realising that state-operated pay-as-you-go pension schemes would run out of breath trying to cope with changing demographics, private provision started to take over. In addition, more and more European investors finally began to believe the truism that, over a longer term, equity investments outperform investments in bonds. And lastly, in several European countries, notably in those whose population had suffered most from the consequences of the (First and) Second World War, for the first time in a century a generation of heirs found themselves in a position to invest more than their modest monthly income surplus in securities.

Technology

After delivering valuable support in the areas of order routing, settlement and clearing, information distribution, and other auxiliary activities of securities trading, information technology started to offer solutions for the exchanges' core activity, the matching of supply and demand, including the finding of a 'best' price for the trades. Electronic trading systems replaced the traditional trading activity on the floors of exchanges where

for centuries traders and brokers had struck their deals under the stringent requirement of physical presence. Communication technology made it possible to link traders in remote places to the trading mechanisms and to carry out (and settle and clear) large numbers of trades between participants that never saw each other.

Soon exchanges, intermediaries and regulators realised that any barriers for foreign investment firms to access to national exchanges were neither timely nor wanted any longer nor could they be realistically upheld. And the single market for financial services had, moreover, become a prime target also for European politicians.

Regulation

Following the opening of the single market for banks in the 1980s, it was the EU's Investment Services Directive (ISD) of 1993 that introduced the single passport principle, most notably for investment firms, but at the same time — and much less noticed — also for 'regulated markets', ie the European Exchanges. From the very moment of the implementation of the ISD in their respective countries, European Exchanges have actively widened their membership, thus offering their issuers access to the international investment community.

European Exchanges today

The European Exchanges of today rightly present themselves as modern, high-tech enterprises. They all operate fully electronic securities trading systems and have (with the exception of the German Exchanges) closed down their floors. They have invited foreign intermediaries to join the ranks of their clientele and many of them do a considerable share of their business with

such remote members.

The majority of European Exchanges today are demutualised. Following the trends illustrated above, namely computerisation and internationalisation, many exchanges realised that their traditional mutual and non-profit structures (which had served them extremely well over many centuries and which had had their clear merits in earlier times) had become outdated and burdensome. Consequently, these exchanges gave themselves a corporate outfit with modern and efficient decision structures and a clear profit orientation. Initially retaining part of the 'membership' concept through a limited circle of shareholders, some have advanced and offered their stock to other groups of their clients (investors and issuers), others again have gone public or intend to do so soon.

In several European countries, whole securities market services groups have grown around the 'traditional' exchanges, ie the cash markets. With very few exceptions, the national derivatives markets are generally found today under the same roof as the national cash markets. Some of these groups went further and also integrated their national clearing and/or settlement institutions, their IT provider, information distribution services and others.

Alliances and mergers

But opening up to foreign (remote) membership and internal restructuring were clearly not enough, particularly not in the eyes of those global intermediaries that — as a consequence, among other things, of demutualisation — were clients and became shareholders of many of the leading European markets at the same time. The benefits of being technically able and legally permitted to link up to any exchange within the EU were

clearly hampered by practical obstacles. Almost every exchange operated its own distinct trading system and every exchange had its own in-house and national regulatory requirements. Through their new, corporate channels of influence, these global financial players eventually started to suggest strongly that their exchanges should develop solutions for a further reduction of costs for those intermediaries operating on more than one market. In addition, and driven by their new for-profit business concepts, exchanges themselves sought methods to curb their expenses. And they arrived at solutions that have indeed been very common in other sectors of the economy for many decades: cooperation, alliances, mergers.

Following the internal concentration process in almost all European countries (today, only in Germany and Spain do regional exchanges still exist), the European Exchanges started different forms of international cooperation. Some, such as ParisBourse, started early on selling their trading system to other exchanges, thus reducing development costs there and at the same time providing foreign members with a trading environment already familiar to them.

'Practical' alliances followed, providing cross-membership and cross-access facilities (eg in the Benelux countries), harmonised listing requirements (eg for the markets participating in Euro.NM) and cross-listings of products, most notably on derivatives markets. The 'European Alliance' of eight exchanges, although eventually perhaps going less far than expected, provided valuable input towards the harmonisation of the European Exchange landscape, for example by defining a joint market model and an effort to harmonise operating hours.

The first cross-border merger of

Figure 1 The European Exchange landscape

exchanges in Europe happened even across the borders of the EU when the national derivatives markets of Germany and Switzerland created Eurex. Recently, another big merger project has become reality: Euronext, the merger of the exchanges of Amsterdam, Paris and Brussels. A new, joint corporate structure has been established by its three participants; the ‘amalgamation’ of trading, clearing, and settlement systems is to follow. Euronext is open for other European Exchanges to join; discussions on this issue have begun, for example, with Lisbon and Luxembourg.

Norex and virt-x, the two other current major alliance projects in Europe rely on the use of one trading system and a common regulatory framework by several exchanges that remain separate legal entities. A similar approach has also been chosen by two smaller European

Exchanges (Vienna and Dublin), who operate their equities markets on the German XETRA system. The XETRA system is also being used by Newex, a niche market established by Deutsche Börse and the Vienna Stock Exchange with a focus on stocks from Central and Eastern European countries. Newex in turn intends to set up cooperations with local exchanges in those countries.

The challenges from alternative types of exchanges

Hardly a month passes without a conference taking place in Europe on a topic such as ‘The Future of Electronic Exchanges’. At many of these conferences, executives from US-based companies are being flown in to present to the European financial community the concept of electronic communication

Table 1 Legend to the FESE chart of the European Exchange landscape
(SE = Stock Exchange)

Cash markets									
EU-EEA-EFTA									
AEX	Euronext – Amsterdam	HEX	Helsinki Exchanges	LON	London SE	STO	OM Stockholm Exchange		
ATH	Athens SE	ICE	Iceland SE	LUX	Luxembourg SE				
BXS	Euronext – Brussels	IRE	Irish SE	MAD	Madrid SE	SWX	SWX Swiss Exchange		
COP	Copenhagen SE	ITA	Italian Exchange	OSL	Oslo SE	VIE	Wiener Börse AG		
DEU	Deutsche Börse AG	LIS	Lisbon and Oporto Exchange	PAR	Euronext – Paris				
Central, Eastern and Southern Europe									
BRA	Bratislava SE (Slovakia)	EST	Tallinn SE (Estonia)	LJU	Ljubljana SE (Slovenia)	SOF	Bulgarian SE (Sofia)		
BUC	Bucharest SE (Romania)	IST	Istanbul SE (Turkey)	MAC	Macedonian SE (Skopje)	TIR	Tirana SE (Albania)		
BUD	Budapest SE (Hungary)	LAT	Riga SE (Latvia)	MAL	Malta SE (Floriana/La Valetta)	WAR	Warsaw SE (Poland)		
CYP	Cyprus SE (Nicosia)	LIT	Nat. SE of Lithuania (Vilnius)	PRG	Prague SE (Czech Republic)	ZAG	Zagreb SE (Croatia)		
New/Alternative markets									
EAS	EASDAQ (Belgium)	NAS-E	NASDAQ Europe (planned)	NEWEX	New Europe Exchange (Austria)	TRP	Tradepoint (UK)		
Derivatives markets									
IPE	Intern. Petroleum Exch. (London)	LME	London Metals Exchange		MIF		the Italian Fixed Inc. Deriv. Market		
LEC	Linked Exchange Clearing	MATIF	MATIF/MONEP (part of PAR)		OM Lon		OM London		
LIFFE	London Int. Fin. F. & Options Exch.	MEFF	the Spanish F. & Options Market		OM Sto		OM Stockholm		
Clearing and settlement									
(CSD = Central Securities Depository)									
CIK	the Belgian CSD (part of BXS)	NECIGEF	the Dutch CSD (part of AEX)						
DeuCl	Deutsche Clearing AG	SIS	Sega Intersettle (Switzerland)						
LCH	London Clearing House								
Non-European exchanges, clearers etc.									
a/c/e	Alliance CBOT – EUREX	CBOT	Chicago Board of Trade	LATIBEX	Mkt for Lat-Am Stocks in EUR (Madrid)	SGX-DT	Singapore Exchange		
ADX	Australian Derivatives Exchange	CME	Chicago Mercantile Exchange				– Derivatives Trading		
ARCHIP	Archipelago (a US ECN)	DJ	Dow Jones (News Service)	MEX	Mexican SE	SydFE	Sydney Futures Exchange		
ASX	Australian Exchange	GEM	Global Equities Market	MONTR	Montreal SE (Canada)				
BM&F	Sao Paulo Comm. & Futures Exchange	HK	Hong Kong SE	NYSE	New York SE (USA)	TOK	Tokyo SE (Japan)		
BOVISPA	Sao Paulo SE (Brazil)	JO'BURG	Johannesburg SE (So. Africa)	PAC EX	Pacific Exchange (USA)	TOR	Toronto SE (Canada)		
		LAT-AM	(several) Latin American Exchanges	SGX	Singapore Exchange				

networks (ECNs), alternative trading systems (ATSs) and similar ventures. Representatives of FESE and/or its member exchanges are occasionally invited to take the role of 'defending' the position of the 'traditional' European Exchanges and are certainly often expected to give account of their battles of withdrawal against the innovative wave.

Expectations are not being met. For the time being, ATSs and ECNs have failed to duplicate to any relevant extent the great success they seem to have in the US. True, in creating and/or exploiting market niches, alternative market operators have found their business opportunities: EuroMTS is a highly successful wholesale trading system for European government bonds — in a sector where European Stock Exchanges had long ago lost much of their business. (It is mentioned above that market participants now seem to love the idea of the government bond market returning into the 'safe harbour' of a regulated market after thriving for many years in an OTC environment.) Coredeal, also a regulated market, successfully entered the wholesale market niche for corporate bonds. And Jiway offers its customers access to a series of major European and North American markets while having the status of an EU regulated market itself.

Several reasons have been identified as to why the market entry for ECNs is certainly much more difficult (if not impossible) in Europe than on the other side of the Atlantic. The two most striking ones are:

- European Exchanges are, technically speaking, ECNs today. All core definition elements usually found in descriptions of ECNs (except the legal one that ECNs are by definition non-exchanges) can also be found at

Europe's fully computerised market places. What a difference to the situation in the US! The New York Stock Exchange and NASDAQ operate in the largest single market of the world; but today are themselves neither electronic nor demutualised.

- European Exchanges operate on the basis of the most advanced market models or have committed themselves to do so in the very near future. They have understood that a central counterparty system with netting facilities across markets, both on the cash and on the derivatives side, is what their members and shareholders want and need. Trade anonymity, paired with an efficient regulatory reporting system of course, is the standard of modern securities trading.

It is with concern, however, that the Federation and its members note a certain development in the regulatory discussions in Europe. Similar to the approach by the US SEC (where ECNs need not necessarily register as an exchange but can be permitted to offer their market services as broker-dealers) some propose to submit ATSs to a lesser degree of regulation and supervision than 'traditional' exchanges. The Federation is not at all convinced that this approach is justified and that the risks evolving from ATSs' operations as market service providers are by nature less than those from 'traditional' exchanges' operations. Far from suggesting a protective environment for FESE's members, we believe that a level playing field for all providers of essentially the same services is more than fair a demand.

The challenge in the back office

In economic terms, European equities markets are not (yet) fragmented. This is to say that basically for every European

financial product there is one key market where 80 or 90 per cent or, in many cases even 100 per cent, of liquidity are concentrated. They are, however, very fragmented in regulatory terms (see below) and in technology.

As mentioned, cooperations, alliances and mergers between some European Exchanges do already address this problem. The real issue is the fragmentation of the cross-border clearing and settlement landscape.

It is well known statistically that the 'cost of trading' on European Exchanges is 'ten times higher than in the US'. This 'truth' stands in striking contrast to the recurrent findings of researchers who actually compare the costs of trading on various exchanges all over the world. Leading European Exchanges regularly finish among the top five (ie among the cheapest) of all securities markets if the mere costs of the exchange transaction are counted. What 'kills' them is the cost of settling and clearing these transactions through a maze of national and international central depositories (CSDs) and clearing houses — including of course the high fees that investment banks often charge their clients to find their way through this maze.

The current consolidation process among European Exchanges and the formation of a handful of pan-European alliances and/or mergers addresses this problem, perhaps to a varying degree in the different projects under way. The ultimate goal of creating cheap and efficient back-office solutions is in any case in the focus of the Federation's members. They know that time is running against them and that successful mastering of this challenge is crucial for the continuing support from their members/shareholders.

The Federation is in the process of evaluating the still rather vague proposal of one single central, non-competitive,

non-profit clearing and settlement agency for all of Europe. While such an idea may seem attractive at first sight, concerns about the disadvantage of any monopolistic structure must not be disregarded. We feel in any case that the formation of a European clearing structure should — as for markets themselves — be left to the private sector.

The challenge in regulation

Regulatory fragmentation in Europe is a fact, given the constitutional structure of the EU and its member states. The single financial market policy of the European Commission tries to reduce the effects of this fragmentation by working towards a removal of barriers between jurisdictions.

The EU Commission's Financial Services Action Plan of 1999 sets out to make decisive steps towards a further improvement of the single market in no less than 43 different areas. The Federation fully supports the thrust of the Action Plan while of course not in every detail subscribing to every proposal put forward by the Commission. We have found, though, that to a much greater degree than in earlier times, the Commission has an open ear to the financial services industry and is indeed actively trying to receive and to process input from market participants, including exchanges. The Federation has received and noted with interest the recent communications by the Commission on the overhaul of the ISD — itself considered the constitution for the unified European Securities Market — on the distinction between sophisticated and retail investors, and on market abuse. These documents provide ample opportunity for discussion by the industry, by and with governments and regulators, and with the Commission and the European Parliament.

This European Parliament has become a true colegislator of the EU through the last revision of the Treaty. European Parliamentarians have therefore become much more interested in — and much more important as targets of — information on developments in the financial sector in Europe. The Federation has therefore cofounded a group of leading European financial service providers and institutions with the aim of providing MEPs with information on trends and issues.

The earlier observation that European regulatory fragmentation is a fact and will remain a given for quite some time to come also provides the answer to the question of whether a joint European Securities Regulator and Supervisor (something like a European Securities and Exchange Commission (SEC) should be established. For the time being and indeed for any foreseeable future, such a European SEC would basically have to operate many separate departments dealing with the regulatory environment (and in particular with enforcement issues) in each EU member state — not a promising outlook.

The FESE strongly believes in regulatory harmonisation but sees much greater potential for success in a strengthened cooperation of the existing national regulators. The Group of Wise Men installed by the ECOFIN Council in July 2000 and chaired by Alexandre Lamfalussy has also strongly recommended such an approach in its recent report. The Forum of European Securities Commissions (FESCO) has started such a cooperation, albeit not yet supported by very much of an infrastructural set-up. The FESE, in line with the proposals made by the Lamfalussy Group, encourages FESCO and its members to continue and to intensify their activities. Proximity to the markets to be regulated has always been

the success story of good regulators — the members of FESCO are those who are and have always been close to their respective home markets. In a European institutional framework, the proposed Securities and Regulators' Committees with their role in fine-tuning legislation can help make European legislation faster and more flexible.

Trans-Atlantic connections

One additional, non-European regulatory challenge should also be mentioned here: While US American market services providers can already today find relatively easy access to clients in some European countries (and, consequently, through single passport arrangements in all of the EU), European Stock Exchanges remain barred from directly gaining US intermediaries and investors as their clients. We believe that European Exchanges today are competitive and ready to compete with their peers in other time zones. Restrictive practices as employed by the US SEC have no place and no justification in today's world of basically free trade. FESE and its members continue their lobbying efforts in the US and have secured themselves the support of the EU and of other international institutions.

It is encouraging to note, however, that the Commodity Futures Trading Commission (CFTC) — the US regulator for derivatives markets — has taken a more open attitude allowing several futures markets the opportunity to offer access to US clients.

An outlook

What will the European Exchange landscape and, more generally, the structure of financial markets in Europe look like in several years time? This is not easy to predict, since not all key

influences are predictable. Nevertheless, the FESE has drawn up a scenario, composed from the interpretation and extrapolation of current trends and from a few desiderata:

- The number of exchanges (securities market operators) in Europe will not decrease, but rather grow through the advent and foundation of new operators. Mergers of exchanges may occur in a few instances, but corporate amalgamation of exchange operators is not really the key issue.
- Local exchanges will be integrated into wider cooperations with joint 'production facilities', ie trading systems. These exchanges will, however, remain the key business partners for their regional clients (issuers, intermediaries and investors). Some will be able to exploit regional and/or topical market niches for a limited time.
- The number of trading systems used by European market places will shrink drastically — this is one of the areas where economies can be achieved by market operators as well as by their clients, ie the intermediaries.
- New types of market operators (ATs in the widest sense) will thrive in certain niches of the market (wholesale markets, bond markets and others). Their 'products' will have life cycles of varying lengths. 'Official Market' and 'Regulated Market' will become quality labels for high-standard markets; their use will have to be monitored and regulated in an efficient and responsible manner.
- It may happen that markets for individual stocks will become fragmented — also for a limited time. Liquidity considerations together with transparency requirements and Conduct of Business Rules for best execution will result in later re-consolidation of market activity.
- The settlement process in Europe will be streamlined and concentrated in the hands of few services providers (or groups of providers), operating on a pan-European scale. The 'monopolies per market' (ie the fixed links between national markets and their national settlement institutions) may be broken up in many places.
- Clearing will likewise be concentrated, although possibly not in one European Central Clearing House — concerns over the disadvantages of a monopolistic solution and over risk concentration may outweigh possible advantages. The key to success, however, lies in cross-netting facilities between clearing houses, across borders and between cash and derivatives markets.
- Despite all further harmonisation of laws and regulations, legal fragmentation will continue to prevail, given the constitutional structure of the EU. Therefore, the idea of a joint European supervisor/regulator seems premature. The cooperation between national supervisors/regulators must and will be extended, FESCO will be put on a stronger institutional basis and its activities will be intensified. Ways will (hopefully) be found to accelerate the legislative process in the Union and to make this process more flexible through the inclusion of regulators and national experts.

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