



The outlook for stock markets: The behaviour of actors and public authorities

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Introduction (1/2)

- Worldwide, exchanges are still major market places for at least equities and interest-rate futures, less so for bonds, swaps and equity derivatives.
- Considerable changes ahead :
 - new regulatory landscape
 - demutualization
 - domestic and cross-border consolidations
 - increased competition between OTC and exchanges

Introduction (2/2)

- Historically most exchanges have been organized along similar lines, their main functions being:
 - Market rules
 - Listing procedure
 - Member surveillance
 - Information services



This model has been now seriously challenged both in Europe and in the US both in terms of interaction with regulators and with their members.

- **The new European regulatory landscape**
- **The exchange demutualization: ownership structure, governance and self regulatory consequences**
- **Cross-border consolidations: the specifics of the regulation of pan-European infrastructures**
- **Issues for the future**

I. The new European regulatory landscape

- **The directives provide for the organisational requirements of regulated markets:**
 - Provisions on the market operators (MIF) and their management
 - Enhanced organisational rules (MIF) against conflicts of interests
 - Reinforcement of their surveillance role and of the detection of fraud (MAD/MIF) :
 - on market participants, with the obligation to monitor potential market abuses;
 - on listed companies, with the obligation for regulated markets to maintain arrangements to verify that issuers comply with their obligations under European law (for initial, ongoing or *ad hoc* disclosure obligations).
 - Harmonization of information rules through Transparency and Prospectus regimes that require a consistent control of the European regulators on issuers' data (PD/TD).

I. The new European regulatory landscape

- **In parallel, the directives aim at creating a common framework for regulating the main types of order-execution arrangements currently active in Europe:**
 - Emergence of a new generation of organised trading systems alongside with regulated markets: the MTFs, with a regulatory regime and responsibilities bearing on the operator which are very similar between the two structures.

I. The new European regulatory landscape

- **As a principle, the directives set a new regulatory framework where differences between the market participants' respective roles are lessened:**
 - the objective is to regulate all markets in a consistent way regardless of their nature;
 - the newly created level playing field will lead exchanges to more and more behaving like investment firms and trying to attract OTC volumes;
 - conversely, the promotion of clients' interests may push investment firms to reducing trading costs and developing in-house execution or multilateral facilities to execute their clients orders.

II. The exchange demutualization: ownership structure, governance and self regulatory consequences

- The trend towards demutualization and listing of exchanges has been developing for the last two decades:
 - at a different rhythm:
 - In Europe, the trend started with the **Stockholm Stock Exchange** at the end of 1992;
 - **Toronto**: the Board of Governors' decision to demutualization was taken in 1998 and in April 2000, the TSE became a for-profit company;
 - In 1998, the government of Singapore started the process to demutualize the SES and Simex to form the **Singapore Stock Exchange**.
 - latest trend in the US:
 - In June 2000, the CFTC approved the **CME** plan to convert into a for-profit corporation: CME is listed end of 2002;
 - In April 2005, the restructuring of the **CBoT** into a demutualization and for-profit Exchange was approved and in June, a possible IPO authorized by shareholders;
 - In May 2005, the **CBOE** chairman announced a possible move towards a demutualized structure.

II. The exchange demutualization: ownership structure, governance and self regulatory consequences

- **Demutualization is both a condition for consolidation...**

- In Europe:

- Euronext and current discussions around the LSE and the Deutsche Börse

- In the US:

- NYSE-Archipelago,
- Nasdaq-Instinet,
- CME-CBoT?

- **... and an incentive for fragmentation**

Intermediaries see as a risk that exchanges structured as “for profit organisations” may consider shareholders’ interests at the expense of market users’ interests:

- Internalisation and development of the OTC market;
- Acquisition of the Philadelphia Stock exchange by banks;
- Debate on the governance structure of exchanges and the level of representation of the users.

II. The exchange demutualization: ownership structure, governance and self regulatory consequences

- **The real question is: does demutualization/listing of exchanges reduce or increase potential conflicts of interests with their self-regulatory function?**
 - When demutualized, could the exchanges be more interested in reducing expenses and therefore less keen on dedicating sufficient resources to meeting their regulatory obligations?
 - When for profit, could exchanges try to develop listing and trading more aggressively, to the detriment of appropriate risk management and their relationship with members?
 - Conversely, when mutualized, could the exchanges be less diligent in terms of surveillance and enforcement of regulatory decisions on the exchange members?
- **Actually, all depends on the monopolistic situation of the exchanges and on the level of fragmentation of the markets**
 - ⇒ Should regulators get involved and influence the composition or on the incentive schemes of the governance structures of the exchanges?

III. Cross-border consolidations: the specifics of the regulation of pan-European infrastructures

- **The directives are still short on the case of transnational exchanges, and the role of the different European regulators for their supervision:**
 - home country principle for the supervision of the regulated market,
 - even if the regulated market is managed by a foreign market operator,
 - special arrangements between the regulators where the operations of a regulated market have become of substantial importance for the functioning of the securities markets and the protection of the investors in a host Member State:
 - Obligation, for the home and host competent authorities to establish proportionate cooperation arrangements.

III. Cross-border consolidations: the specifics of the regulation of pan-European infrastructures

- **The creation of Euronext prompted regulators to reinforce their cooperation out of any legal framework:**
 - In 2001/2002, regulators of four European Member States
 - the French AMF, the Belgian CBFA, the Portuguese CMVM and the Dutch AFMhave agreed a Memorandum of Understanding to co-ordinate the supervision and regulation of Euronext's market activities and the associated regulated markets it operates.
 - Following the acquisition of the signed the MoU in March 2002.
 - It was the first multilateral MoU designed to regulate a multi-jurisdictional cash and derivatives exchange.
 - In March 2003, these four regulators, together with the FSA, also agreed on the provisions of a separate MoU in relation to all of Euronext's derivatives market activities.

III. Cross-border consolidations: the specifics of the regulation of pan-European infrastructures

- **This co-operation aims at setting up a coherent regulatory framework to foster the efficiency of the regulatory system.**
- **Under this MoU, some decisions made by the Euronext group are subject to the prior decision of the Chairman's Committee:**
 - alliances, mergers, cross shareholdings and cross membership agreements;
 - outsourcing of activities related to trading, registration and publication of transactions, surveillance of members' activity, monitoring of transactions;
 - modification of the Euronext Rulebook (harmonized market rules).

III. Cross-border consolidations: the specifics of the regulation of pan-European infrastructures

- **From a legal point of view, there are still many impediments to the full cross border integration of exchanges:**
 - Euronext is still operating as a separate market in each national jurisdiction where it is set up.
- **But a strong pressure towards harmonization of rules and of the regulatory framework:**
 - Common governance scheme;
 - Common trading rules;
 - Need for a more common view on the exchange's monitoring role on the markets and its members.

- **Issues for the future**

- **Further consolidation? Further fragmentation? What are the respective risks of increased cross membership, outsourcing, or concentration of activities?**
- **New developments from an institutional prospective towards a further and larger convergence of supervisory practices?**
 - CESR Himalaya Report and its follow-up
 - New information-sharing arrangements between regulators
 - Data consolidation under the MIF and Transparency directives
 - Coordination of regulatory responsibilities for transatlantic trading of derivatives and post market infrastructures (CESR-CFTC agreement)

Is it enough? Is there a need for better and deeper integration between European regulators? Should there be a control on the shareholding structure of exchanges? Should there be a segregation between commercial and regulatory functions?

- **Issues for the future**

- **It seems paradoxical that the demand for market consolidation in Europe could lead to a fragmentation of post market infrastructures:**

- Debate on the ownership structure of LCH-Clearnet and Eurex-Clearing on the occasion of the negotiations around the LSE and subsequent recommendations from the British Competition Commission
- Is there a specificity for post-trade activities compared to trading, which would justify a different regulatory approach towards the set-up of a utility-based system.

- **Issues for the future**
- **This new environment is an opportunity for regulators to rethink their approach towards a risk-based balance, with:**
 - a better identification of the potential additional risks:
 - Fraud risk
 - Liquidity risk
 - Solvency risk
 - Market risk
 - Competition risk
 - a definition of an appropriate regulatory system tending to promote a level playing field between all actors,
 - and still enough flexibility to foster market participants innovation
- **... while continuing to actively contribute to market integrity and investor protection.**