Current Issue

Deutsche Boerse and NYSE Euronext: A Dubious Union

The ecomonic implications of Deutsche Boerse's proposed NYSE Euronext acquisition.

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Deutsche Boerse's proposed acquisition of NYSE Euronext has troubling implications for New York City's economy and the U.S. financial sector. There should be a moratorium on European - U.S. exchange consolidation until regulations are more closely aligned and anti-competitive aspects of the proposed acquisition are changed.

U.S. Securities Exchanges' Two Disadvantages

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U.S. exchanges regulated by the SEC suffer from two significant disadvantages in raising capital to buy non-U.S. exchanges. First, the SEC rules that promote exchange competition are tougher than rules outside the U.S., and thus the margin American exchanges earn from matching trades is lower than it otherwise would be. These rules have greatly benefited market participants and American investors, but they lower profitability and handicap U.S. securities exchanges as international exchange consolidation accelerates. Second, U.S. securities exchanges do not clear trades, and thus lack an important source of revenue and profits. By contrast, futures exchange regulation limits competition and allows clearing. The CFTC, unlike the SEC, does not require that member firms route trades to the exchange displaying the best price (best execution) or that exchanges participate in a National Best Bid and Offer (NBBO) system. Futures exchanges do not face competitive threats from Alternative Trading Systems (ATS). Also, the largest futures exchanges are vertically integrated, owning their own clearinghouses. Thus, U.S. futures exchanges do not suffer similar disadvantages regarding international consolidation.

NBBO Systems Intensify Competition

The SEC mandates that equities exchanges and equity options exchanges participate in NBBO systems, where stock and stock option prices (bids and offers) from all exchanges are continuously displayed. The two U.S. equities and equity options NBBO systems facilitate intense competition among exchanges. For example, in the last several years, the BATS Exchange (granted exchange status in 2008) and Direct Edge (granted exchange status in 2010) have gained significant market share against NASDAQ OMX and NYSE Euronext. Direct Edge's U.S. equities market share is about 11%, and BATS' is 10%. NYSE Euronext's 2011 market share in matched trades is about 33%, down from 61% in 2007. NASDAQ OMX's market share is 18%. The

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remainder of the market represents trades matched by ATSs. Without the support of an equities NBBO system, it is unlikely that BATS or Direct Edge could have gained market share so quickly. In the equity options market, the International Securities Exchange's (ISE) market share increased from 0% when the ISE launched in 2000 to over 30% in 2005. (It is now about 18%).

The ISE's rapid gain in market share, and gains by competitors who subsequently entered the market such as BATS Exchange, NASDAQ OMX and NYSE Euronext, were facilitated by the equity options NBBO.

U.S. and E.U. Securities Regulation

The equities NBBO was established by the Securities Exchange Act (1975) and by the early 1980s, the NBBO had become widely disseminated and perceived as the foundation of the U.S. National Market System (NMS). The SEC substantially strengthened the NBBO system in 1998 (Regulation ATS) and in 2005 (Regulation NMS). The U.S. equity options NBBO began in 2001 and was enhanced over the next few years. By contrast, Europe introduced new rules of exchange competition via MiFID (Markets in Financial Instruments Directive) in late 2007. Technology vendors have developed European BBO systems, but Europe does not yet have a common system that includes all equities exchanges and presents an integrated view of the equities market, or similarly the equity options market. Consequently, Deutsche Boerse had little competition before 2008, and still does not face comprehensive European BBO systems in its home market. Also, like many European exchanges, Deutsche Boerse enjoyed a de facto clearing monopoly, where trades executed on Deutsche Boerse exchanges cleared on Eurex Clearing, a subsidiary.

However, in the last several years E.U. regulators have encouraged competition in securities clearing. The European securities clearing market is now quite different than the U.S.'s outdated model, where securities clearing is provided by industry utilities, denying the possibility of competition. The Depository Trust and Clearing Corporation (DTCC) clears equities and fixed income trades (plus offers settlement and depository services), and the Options Clearing Corporation (OCC) clears options trades. Ironically, DTCC's European subsidiary, EuroCCP, benefits from the E.U.'s promotion of competitive clearing.

Anti-competitive Aspects

Finally, if the Deutsche Boerse's acquisition of NYSE Euronext is approved without changes, competition will be reduced in U.S. securities markets. The ISE is a subsidiary of Deutsche Boerse and therefore Deutsche Boerse would gain a 33% ownership in Direct Edge. More critically, Deutsche Boerse would own three U.S. options exchanges, NYSE Euronext's Amex and Arca plus the ISE, controlling about 44% of the U.S. options market.

A Moratorium

In summary, U. S. regulators should act to prevent excessive consolidation in the U.S. equity options market. Also, U.S. and European securities market regulations are still substantially different, and until they are more closely aligned, there should be a moratorium on European - U.S. exchange consolidation. Currently there is more competition in securities trading in the U.S. than in Europe, but no competition in securities clearing. U.S. regulators should urge the E.U. to adopt comprehensive European BBO systems for equities and equity options. In parallel, U.S. regulators should adopt rules that encourage competitive clearing, leaving for now the securities settlement and depository functions as utilities. Competitive clearing would stimulate innovation and lower clearing fees, benefiting American investors. By offering clearing services, U.S. securities exchanges would gain new opportunities to grow, improving their ability to compete internationally.

About the Author: Wayne Arden was V.P. of Sales for NASDAQ OMX's Market Technology division in the Americas from 2003 - 2008, focusing on exchanges, alternative trading systems, clearinghouses, and depositories. In earlier positions at IBM and elsewhere, Arden focused on brokerage and compliance systems, software and systems engineering, marketing, and business strategy. Mr. Arden holds a BA from Dartmouth College and an MBA and MS from Columbia University. Since February 2009 he has been an independent consultant, concentrating on financial technology and clean technology.

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