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The future of European stock markets

Alasdair Murray

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ABOUT THE AUTHOR

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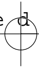

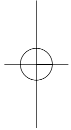

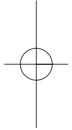

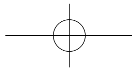

FOREWORD

It is nearly a decade since the EU was supposed to have created a single market in financial services. During the 1990s Europe's equity markets and securities firms evolved rapidly. Yet the EU's legislative framework has lagged badly behind. Investors, securities firms and European businesses still cannot reap the benefits that a truly pan-European equity market would offer.

The absence of a coherent single market in equities is damaging the overall competitiveness of the European economy. The cost of capital is higher than it should be, which is one reason why Europe is failing to create enough new businesses. Savers are deprived of the chance to invest in a larger and more liquid capital market. Securities firms cannot take advantage of economies of scale that that would enable them to compete with their international counterparts on equal terms. The full economic potential of the single currency will never be realised until the obstacles to cross-border share trading are removed.

Meeting in Lisbon in March 2000, the EU's leaders promised, as part of their efforts to create "the most competitive and dynamic knowledge-based economy in the world", that they would tackle the lack of a single market in financial services. There is a growing understanding that unless the legislation governing EU equity markets is overhauled, Europe will never be able to match the economic performance of the United States.

It is vital that well-meaning words are now turned into sustained action. The EU institutions are running out of excuses for their failure to move forward with reform. An outline legislative agenda already exists in the form of the Commission's Financial Services Action Plan. Now the required single market legislation must be put in place as quickly and efficiently as possible. The Lamfalussy Committee's recent report suggests the EU should be able to make progress by more effectively employing the existing institutional framework.

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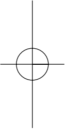
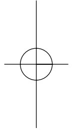
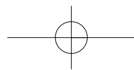
I am delighted that the two companies of which I am chairman, Goldman Sachs International and BP p.l.c., have supported the work that has gone into this excellent pamphlet. Alasdair Murray's sharp analysis and timely proposals will provide a vital contribution to the growing debate on the future of the European equity markets.

Peter Sutherland







Introduction: the case for reform

The creation of a single market in financial services is one of the European Union's great unfinished projects. While Europe has found the will to push ahead with more ambitious schemes, such as the euro, its attempts to liberalise financial services have faltered, hampered by political disagreements and the EU's cumbersome legislative apparatus.

The slow pace of reform in financial services is keenly felt above all in Europe's securities markets. Although there has been some increase in cross-border share trading in the last decade, equity trading across Europe's borders is still expensive compared with the United States. The European Central Bank (ECB) has calculated that the total stock market capitalisation of the euro-zone as a proportion of GDP stands at just half the level of the US. Business in the euro-zone continues to rely heavily on bank lending for its financing needs.

The failure to create a single market for equities has two important consequences for the European economy. First, it makes it more difficult for Europe to compete with America. Equity markets help to raise competitiveness levels through the efficient allocation of capital, by mobilising savings and by disciplining management. The size and strength of US equity markets has been a key factor in America's robust economic performance during the last decade.

Access to low cost capital has helped foster a vibrant venture capital industry and enabled the US to steal a lead in the creation of "new economy" technology businesses. This lead has not just been confined to the overhyped "dot.com" sector. It is also apparent amongst the software and bio-technology businesses which are much more likely to contribute substantially to economic growth in the future. Per head of population, the US has access to five times as much venture capital as Europe. The euro area may be on the verge of out-performing the US economy for the first time in ten years, yet most economists agree that Europe's long-term growth potential still lags behind that of the United States.

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Second, the lack of an integrated market in European equities means the euro area is not yet able to enjoy the full benefits of the single currency. While investors no longer face currency risk when purchasing shares in other euro-zone countries, the obstacles to and extra costs of cross-border share trading mean that capital is not being allocated in an efficient manner. There are 15 very different regulatory systems governing exchanges and trading across Europe as a whole. Companies employ different accounting systems for their financial results; there are different rules for the reporting of trades; and brokers and financial institutions face a range of restrictions in the products that they can sell into the retail market.

The euro has in itself helped to expose this anomaly. With exchange rates no longer a barrier to equity trading within the euro area, the regulatory and structural obstacles have become even more apparent. In contrast, Europe's lightly-regulated bond market has rapidly become integrated. Although the euro debate in Europe has largely focused on the macro-economic implications of the single currency, micro-economic factors will prove just as important in the long term. The euro is intensifying competition, forcing businesses to restructure and governments to speed up economic reform.

A number of other factors also suggest the urgent need for equity market reform within the EU. Many European countries desperately need to overhaul their pensions systems as ageing populations become a growing burden on state finances. One answer is to adopt a private pension model, encouraging individuals to make private provision through equity-based pension funds. This in itself would further stimulate the development of European equity markets, boosting liquidity and thus reducing the cost of capital.

EU leaders recognised the importance of creating a single market at the Lisbon European Council in March 2000. They reached a consensus on the enabling legislation, including European prospectus rules and common accounting standards, that would be required to increase cross-border share transactions. And they established a deadline of 2005 for completing the legislative programme. At the Stockholm summit in March 2001, EU governments unanimously gave their support to proposals designed to speed up the passage of this much-needed securities legislation.

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However, the recent downturn in international equity markets may yet test the depth of commitment to reform. Unlike the US, much of Europe has yet to develop a genuine "equity culture". The collapse in tech stocks, in particular, could quickly turn public opinion against the markets. While the major European stock indices have suffered some of the steepest falls in nearly a decade, "new economy" stocks have been hardest hit. The value of the Neuer Markt, the German market for hi-tech stocks, declined by 80 per cent in the year to March 2001.

Most stock prices have only returned to the levels of 1998 – and market analysts would still describe the decline largely as a much-needed "correction" rather than a crash. However, many small investors have had their fingers burned. If the downturn becomes a prolonged bear market, the EU's liberalising agenda is bound to come under attack.

Europe's politicians could react by defensively placing restrictions on cross-border share trading. While such an approach may provide some short-term protection for small investors, it would further undermine the overall competitiveness of European markets. It would make it more difficult for companies to raise cheap finance and for pension funds to seek out the best returns. Despite the Lisbon commitments – which have been reaffirmed at Stockholm – the EU cannot simply assume that the case for a single market in equities is already won.

A question of governance

Even without the distraction of the downturn in international equity markets, the outlook for thorough legislative reform in EU equity markets is not entirely promising. The issue goes to the very heart of the debate about the EU's governing apparatus. Previous attempts at developing new legislation for the equity markets have been hamstrung by problems characteristic of today's Union: painfully slow decision-making, uneven implementation and political compromises that satisfy no-one.

As a result, demands for a radical overhaul of the legislative process, from both the private sector and member-state governments, have grown in recent years. Some critics of the EU's current institutional apparatus have even begun to float the idea of the creation of a European version of the US Securities Exchange Commission. For the moment, however, EU political leaders have steered clear of endorsing a radical institutional

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solution. At Stockholm, member-state governments endorsed the much more modest recommendations of the Lamfalussy committee.

The committee has sought to introduce some coherence to the current EU institutional apparatus, which Baron Lamfalussy has memorably described as "a remarkable cocktail of Kafkaesque inefficiency that serves no one". The committee has proposed the creation of a powerful new EU Securities Committee, to help maintain the reform impetus and to supply the technical details for new legislation. This would leave the Council of Ministers and the Commission free to focus on broad-brush framework legislation. The Lamfalussy Committee has also suggested the formal establishment of an EU Regulators Committee, a successor body to the existing Forum of European Securities Commissions (FESCO), which would play a supporting role in the preparation of the technical aspects of legislation and improve co-ordination between national regulators.

The creation of a successful Securities Committee would help ensure that redundant legislation can be updated much more quickly. However, the Commission and the new proposed EU Regulators Committee would also need to take a much more aggressive role in ensuring proper implementation. Both a regular report which "names and shames" governments dragging their feet on implementation, and an annual finance ministers' meeting dedicated to reviewing the securities markets, would be major steps forward. The Commission should also show greater willingness to take infringement cases to the European Court of Justice. This is a slow process, but is vital if the integrity of the single market is to be maintained.

Private sector reform

For all the improvements that can be made in the regulatory environment, it should not be forgotten that the private sector also has an important role to play in establishing a single market in European equities. Not all the extra costs of cross-border trading in Europe derive from regulatory failings. European exchanges and the clearing and settlement companies, which process the trades, have come under growing pressure from the major securities firms to reduce their costs and create a more liquid market in the major European stocks.

The exchanges have been most active, launching a series of mergers and takeover attempts during the last year. Although some further

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consolidation amongst exchanges is inevitable, there is little evidence that large-scale mergers or takeovers will lead to substantial savings. Indeed, competition between exchanges – and more recently with non-exchange share trading firms – has been a spur to reducing costs across European markets. It is much more likely that major savings can be made by encouraging consolidation amongst the clearing and settlement firms.

A vital national interest

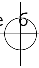
London's position as the predominant financial centre in Europe ensures that the future of the EU's financial markets is clearly an issue of national importance to the UK. Indeed, the health of London's financial services sectors forms one of Chancellor Gordon Brown's five "economic tests" for euro entry.

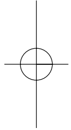
Yet there is a curious mix of complacency and paranoia in the City's approach to the subject, much of which was clearly on display during the attempt by the London Stock Exchange and Deutsche Börse to merge as iX. There is a feeling that any new European initiative is either a cunning plot to diminish London's competitive advantage or is doomed to failure because the rest of Europe lacks the City's financial acumen.

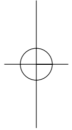
This is understandable in the sense that, as the largest financial services market in Europe, London has potentially the most to lose. On the other hand, it also has the most to gain from the creation of an effective single market in financial services. The sheer size of the City of London means it enjoys a lead over other European financial centres that will be difficult to erode.

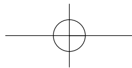
The British government is increasingly impatient to push ahead with the completion of the single market in all financial services. Ahead of the Stockholm summit both Downing Street and the Treasury made legislative reform of the European stock markets one of their key EU policy targets. Yet the government sometimes seems to share the City's ambivalent attitude. Britain has in the past not only failed to take a convincing lead on equity market integration in Europe but also, at times, been forced on the defensive.

The next chapter will examine in more detail the relationship between stock markets and economic growth.









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1 Catching the United States

> "If Europe's economies are to compete, the cost of capital must come down and it must become easier for individuals to deploy capital where they are going to get the best return. At the heart of that is the exchange. Delivering lower costs and deeper liquidity across European markets is an essential component of the economic restructuring of Europe. On that basis we can take on America in rather more effective competition."
>
> *Don Cruickshank, chairman of the London Stock Exchange, May 2000*

Raising Europe's growth potential

Until relatively recently, there was a strong belief that equity markets were largely an economic by-product rather than a major factor in promoting growth. Financial services in general were viewed as passively responding to the needs of businesses rather than an economic stimulus in their own right.

In continental Europe, where banks have dominated business financing through debt issuance and lending, some economists even saw equity markets as a potential obstacle to long-term growth. This view, shared by centre-left thinkers in Britain and the United States during the 1980s, characterised shareholders as more interested in quick profits than the long-term health of businesses. The critics of stock market capitalism insisted the arm's-length relationship between owners and managers in quoted companies led to undisciplined management.

However, the economic experiences of the last decade have undermined this argument. Countries such as Japan and Germany, where the banking sector is strong, have lagged more equity-based economies, particularly the United States. The anti-equity arguments have been thrown into reverse. Critics of Japan's economic under-performance in the 1990s point to the

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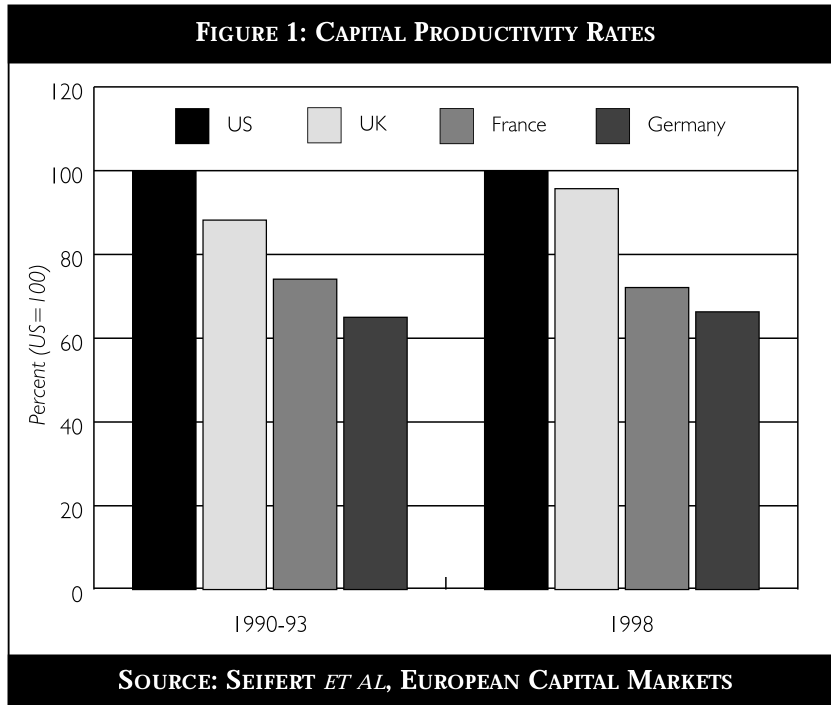
cosy relationship between the banking and corporate sectors as a major obstacle to urgent restructuring. In contrast, the arm's -length shareholder/manager relationship has appeared far more responsive to the disciplines of the market and consequently more likely to ensure the prosperity of a company over the long term.

This view is supported by a growing body of empirical evidence which suggests that financial markets in general, and stock markets in particular, are key elements in improving overall economic growth rates.[1] The research emphasises the role that equity markets play in raising levels of competitiveness through the efficient allocation of capital, by mobilising savings and by helping investors to exert corporate control.

[1] See for instance Levin and Zervos, "Stock markets, banks and economic growth", American Economic Review, 1998

The key relationship appears to be between market turnover – the total value of share trading – and overall growth levels. A high market turnover is a good proxy for the efficiency of equity markets as it implies high

FIGURE 1: CAPITAL PRODUCTIVITY RATES



SOURCE: SEIFERT *ET AL*, EUROPEAN CAPITAL MARKETS

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liquidity, low trading costs and consequently firms enjoy access to cheap capital. In their study, Levine and Zervos suggest that for every ten percentage point increase in the value of share trading, overall economic growth levels increase by as much as one percentage point.

This important relationship is supported by an analysis of capital productivity rates (see Figure 1) – a measure of how efficiently all forms of capital are employed within the economy. Some figures from the McKinsey Global Institute, which are extrapolated in Werner Seifert's book *European Capital Markets*, underlines the vital role played by stock markets in the effective allocation of capital. Although capital productivity rates in Europe have improved since the early 1990s, on average they still lag those in America by around one-third. Britain, however, succeeded in reducing the productivity gap with the US from 12 per cent at the beginning of the 1990s to just 5 per cent in 1998.

The strong correlation between higher growth and dynamic equity markets is clear (see Figure 2, overleaf). During this same period the value of shares traded in Britain rose by 36 per cent. France suffered a small decline in its capital productivity rates. While market volumes increased, they rose at half the rate recorded in Britain. France, it should be noted, also imposes more complex capital restrictions and has fared less well in the promotion of new hi-tech stocks. The growth rate of the French economy has improved during the last couple of years, but over the whole of this period lags that of the United States and Britain.

The importance of improving capital productivity rates for long-term economic growth cannot be over-stated. Mr Seifert, the chairman of Deutsche Börse, argues that had Germany managed to achieve capital productivity rates close to US levels, its total GDP would stand between 8 and 10 per cent higher than at present.

Recent research has also found that a high overall level of financial development appears to increase the rate of new business creation, but only has a limited impact on the growth rate of established companies.[2]

This is particularly important in the development of "new economy" businesses. Sectors such as pharmaceuticals and computers are highly

[2] *See Raghuram Rajan and Luigi Singales, "Financial Dependence and Growth", American Economic Review, June 1998*

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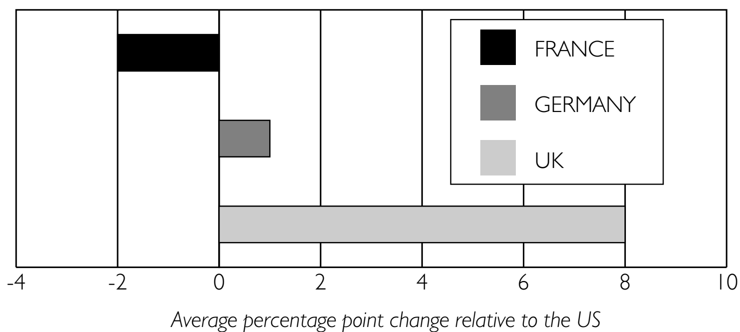
dependent on external financing for the pursuit of their growth strategies. In the US, venture capital firms have been particularly adept at exploiting opportunities in the "new economy". The attraction of an exchange like NASDAQ is that it provides a quick and easy means for venture capitalists to realise their investments. The position in Europe is improving. However, even the new high-tech markets – such as EASDAQ in Brussels or the Neuer Markt in Frankfurt, designed to attract venture capital flotations – remain relatively small. Although not the only explanation, the strength of the US capital markets has undoubtedly helped America to steal the lead in "new economy" businesses.

FIGURE 2A: CHANGE IN TURNOVER RATIO (1990-1998)

FIGURE 2B: CHANGE IN CAPITAL PRODUCTIVITY (1990-1998)



SOURCE: SEIFERT *ET AL*, EUROPEAN CAPITAL MARKETS

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Finally, it should be noted that financial services companies also have a positive direct economic impact. Compared with other sectors in the economy, a large proportion of jobs in financial services are high-earning. Economists estimate that the economic value added by financial services companies is twice the average level in the rest of the economy, rising to as much as three times in Britain.

Financial services have also benefited from new technologies. In Britain, it is this sector that has recorded the greatest productivity gains during the last few years. The financial services industry is now a major part of the British economy. The surplus on trade in services – of which financial services exports are a major part – has helped to minimise the country's overall trade deficit in recent years, despite the persistently strong pound.

This is why Britain is peculiarly sensitive to any EU legislative initiatives in this area. But the City of London also acts as Europe's financial centre. The Centre for Economics and Business Research (CEBR) estimates that 80,000 jobs in the City depend in some way on other European Union economies for their existence.[3] Most major European financial firms have a significant presence in the City, while a substantial proportion of London trading is carried out in EU currencies, derivatives and securities.

The CEBR also claims that the concentration of financial services in London has substantial cost-saving benefits for all EU firms. The report estimates that EU customers save around €13bn a year by using the City to do business. If these services were lost from London, the CEBR argues that only half would relocate elsewhere within the EU. A quarter of these services would be lost altogether – directly reducing overall EU GDP by 0.17 per cent and leading to the disappearance of 110,000 high-value jobs.

As the analysis of the wider importance of equity markets to economic development suggests, the EU as a whole would benefit from a more integrated single market in financial services. Expanding equity markets would generate new jobs in all the major European financial centres, even if one centre remains predominant. Distance from New York has not stopped Silicon Valley taking the lead in new economy stocks. Ultimately, both a reduction in the cost of capital for companies, and improved

[3] See "The City's importance to the European Union economy", Centre for Economics and Business Research/ Corporation of London, November 2000

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investor returns will have the greatest economic impact. But in these areas Europe will require a major effort to catch the US.

Developing an equity culture

On a wide range of measures Europe is beginning to develop an equity culture. The number of initial public offerings in EU markets increased from about 500 to about 700 a year in the period 1997 to 1999. The number of private shareholders has steadily increased due to major privatisation programmes, most recently in Italy, France and Spain. France, typically portrayed as the most resistant to change, has seen a 40 per cent rise in the number of people purchasing equity-based unit trusts between 1998 and 2000. However, overseas investors have been more active on the French bourse than domestic financial institutions. The country's top 40 firms – including names such as LVMH and L'Oréal – are majority-owned by international investors. In total, nearly 40 per cent of the Paris Bourse's capitalisation is owned overseas.

Cross-border equity trading has also been rising rapidly, by around 20 to 25 per cent a year. The Deutsche Post flotation at the end of 2000 was marketed in several other European countries, attracting 30,000 small investors from the UK alone. Stock market capitalisation has increased in all European countries, but much more rapidly in some. In Belgium, stock market capitalisation grew from 32 per cent of total GDP in 1991 to 80 per cent in 2000, while in Italy it rose from 15 per cent to 70 per cent.

Despite these advances, Europe and the euro-zone in particular – which excludes share-loving Britain and Sweden – still lag America. With stock market capitalisation at half the level of the US, the euro-zone continues to rely on banking loans (see figure 3). At the end of 1999, traditional bank loans to the corporate sector alone amounted to 45 per cent of euro-zone GDP, compared with just 12 per cent in the US.

On other measures, Europe performs poorly. While direct private share ownership in Germany climbed by a quarter during 1999 to six million people, this represents less than in one-in-ten of the population. In contrast, 62 million, or more than one-in-four Americans, own shares directly, rather than via a pension fund or mutual fund. The US is also well ahead in terms of institutional investment. Over-zealous regulation in a number of European countries has restricted the proportion of a mutual

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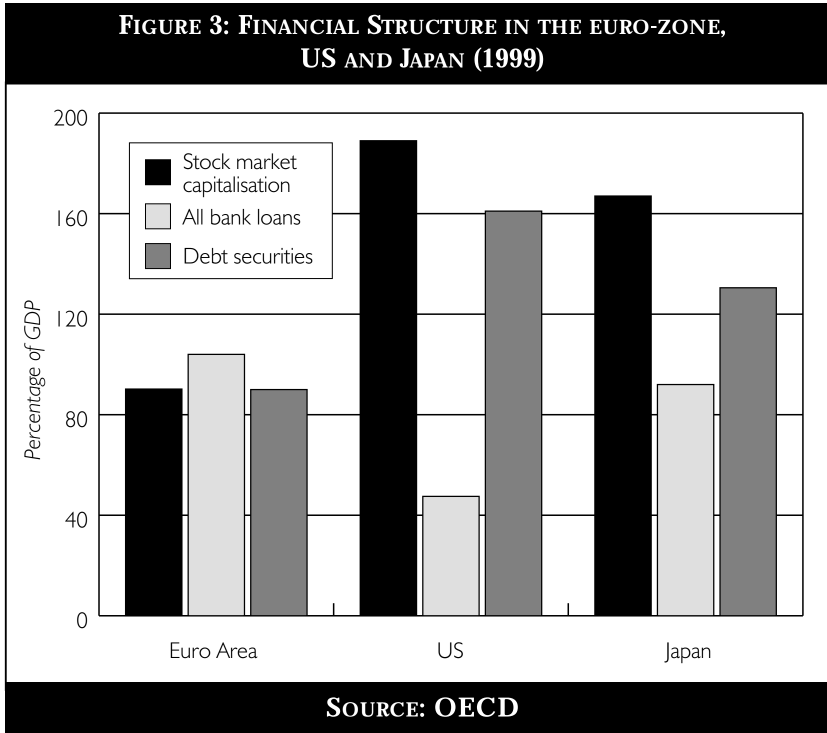
FIGURE 3: FINANCIAL STRUCTURE IN THE EURO-ZONE, US AND JAPAN (1999)



SOURCE: OECD

fund that can be invested in equities – especially in the pensions sector. In 1999, an average of 40 per cent of European investment funds were in equities, compared with 60 per cent in the US.

Yet the benefits of a more equity-orientated approach to pension fund investments are clear. European Commission research shows that during the period from 1984 to 1998 the average real return on pension funds was 10.5 per cent in the United States but just 6.3 per cent in those European countries which heavily restricted the investment strategies of pension funds. This period, it should be noted, includes the stock market crash of 1987 but not the technology-led equity bubble of 1999 and 2000.

Much of the competitive advantage enjoyed by US equity markets comes from their sheer size, in part the result of decades of official encouragement of equity-based private pensions and mutual funds. It will take a substantial increase in European stock market participation rates for the

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gap to be closed. The Commission has estimated that if all EU member states achieved a level of private pension provision similar to the high Dutch levels, some €5 trillion would be released into the capital markets during the next ten years, much of it destined for shares.

Despite a growing body of evidence on the economic benefits of deep and liquid equity markets, the intellectual case for further integration of European stock markets is not yet won. The recent collapse in technology stock prices and the more general uncertainty in global equity markets will only make it harder to win this argument. Yet recent stock market losses and the risk of a US recession cannot disguise the fact that America in the 1990s enjoyed its longest period of economic expansion this century.

The connection between equity market development, economic growth rates and the creation of new businesses needs to be more explicitly stated. The Commission has indicated that it is willing to try hard to make the case that reform of equity market regulation is vital to the health of the EU's economy. This work needs to be made a priority, especially at a time when short-term stock market volatility may distract political attention from the longer-term economic benefits of reform.

2 A regulatory affair

> "We can no longer afford the luxury of regulatory inefficiency in the instantaneous internet age. Financial markets are changing by the week and European regulation is simply not up to speed."
>
> *Baron Alexandre Lamfalussy,*
> *chairman of the Lamfalussy Committee, November 2000*

Who's afraid of a Euro SEC?

The creation of a powerful European equivalent to the US Securities and Exchange Commission is an idea with no apparent author. While the media has frequently alluded to the possibility of establishing a "Euro SEC", no politician has made public his support and no official has drafted a blueprint. Until the Lamfalussy committee (see below) made a brief – but significant reference – to the concept in its final report, it was easy to dismiss a Euro SEC as media hype.

Yet the idea that a Euro SEC is on the EU's agenda has taken root. In London, the finger of blame has inevitably, if somewhat unfairly, pointed to Paris – although the French position is a touch ambiguous. French officials react by joking that they have already bought the land for the new institution's headquarters – before hastening to add that they have no such plans at this stage. One senior French official dismissed the idea that the Lamfalussy committee was a Trojan horse for the creation of a Euro SEC, adding that "people think the French are much cleverer than they are in reality." French officials suggest instead that the Euro SEC idea was born in Rome, although Luigi Spaventa, the Italian representative on the Lamfalussy committee, has been careful to distance himself from the concept.

Even without formal advocates, it is not difficult to understand why a debate over the merits of a Euro SEC has sprung up so rapidly. The logic of a single institution to monitor and regulate Europe's securities markets

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is seductively simple. What more certain way to ensure the single market in equities becomes a reality than to create a single centralised body? A Euro SEC would iron out differences in conduct of business rules, ensure uniform implementation of regulations and be able to respond quickly to new developments in the markets. Investors would benefit from equal protection across all European markets. Instead of having to deal with 15 national regulatory authorities, businesses would visit a one-stop shop for compliance issues. The cost savings for the major financial institutions would be substantial. This is why, contrary to the belief in the London media, there is if not outright support at least some private-sector interest in the Euro SEC idea.

The concept of a Euro SEC also fits squarely into one current trend of EU institutional thinking. A Euro SEC would represent a further step towards expanding Europe's technocracy. A stand-alone institution, it would be beyond the direct control of the European Commission. The parallels with the European Central Bank are clear. Like the ECB, a Euro SEC would be staffed with experts rather than politicians. It would have a degree of operational freedom to ensure its decision-making process was thoroughly depoliticised.

In Britain, eurosceptics quickly seized on the concept, real or not, as another example of the EU's centralising tendencies. The suspicion plays on sensitivities about the City of London's position *vis-à-vis* the euro-zone. The fear is that a Euro SEC would destroy London's competitive advantage over the continental European financial centres.

However, few doubt that the creation of such a body would present huge practical difficulties. The establishment of a securities regulator is technically complex. The bill to set up the Financial Services Authority in Britain attracted 2,278 amendments including 1,470 from the government itself. It would not be overly cynical to expect some unholy political horse-trading over the fine detail of the necessary European legislation, let-alone the customary back-room bartering over which country should host and which individual should head the new organisation.

For the Euro SEC to possess any real powers would require a degree of legal harmonisation unseen within the EU. The laws relating to securities markets cut across a wide range of legal areas – company, property and

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criminal law – and vary substantially from country to country. Germany, for instance, would even need to amend its constitution, as the *Länder* have the power to regulate their own financial markets. Hans Eichel, the German finance minister, recently announced plans to try and consolidate all the various German regulatory authorities in one institution – similar to the Financial Services Authority in the UK – but the proposed reform has run into substantial opposition from the *Länder* for precisely this reason. To be effective, the regulator would also need to be able to bring criminal prosecutions for certain actions such as insider dealing. But under whose laws and in which courts? This raises the sensitive question of whether the EU needs a European public prosecutor.

It would be wrong to model a Euro SEC on the European Central Bank. Unlike the ECB, which only has competence in the specific area of monetary policy, a Euro SEC would affect directly and very broadly individuals and businesses through its regulatory functions. Simply replicating the ECB institutional model, with its limited mechanisms for accountability, would be unacceptable. Securities regulation is not just a technical matter, for it touches upon fundamental property rights. Yet to make a Euro SEC fully accountable to representatives of investors, securities firms and national politicians would greatly impair its efficiency.

A Euro SEC would also need to be a large organisation if it was to be effective. The French Commission des Opérations des Bourses (COB) makes around 5,000 decisions a year on issues ranging from compliance with listing particulars to cases of market abuse. A European body could expect to deal with more than 50,000. A single body based, say, in Paris could not easily make effective decisions on issues, many of them minor, occurring in markets in the far-flung corners of the Union. Neither would this be appropriate, on the grounds of subsidiarity – the principle that decisions should be devolved to the most suitable tier of government. Europe's financial markets are at different states of development and it is not clear that what is practical and effective in London is suitable for Lisbon or, in the near future, Budapest and Prague.

The issue of consumer protection is crucial in this regard. It is hard to see how a regulator based in a foreign city can provide effective protection against firms that indulge in dubious or illegal selling practices. The principle of mutual recognition implies that national regulators are best

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placed to monitor the activities of securities firms operating on their territory. However, both national and European parliamentarians are also likely to insist that private investors are protected in their own language and by their own courts. Europe needs not a single body but a network of ombudsmen to ensure consumers can seek redress at a local level. Consumer protection is also intimately bound up with the tax and pensions systems – issues that remain the preserve of the nation-state. Permitting an EU securities regulator to intervene in this context would raise some profound questions about legitimacy.

Another area where the subsidiarity principle should apply is market manipulation. There is considerable pressure within the EU, especially from the European Parliament and national regulators, for the introduction of a draft directive on market manipulation. But while it has been possible to advance on the specific issue of insider trading, the broader definition of market manipulation is more problematic. There is often a fine line between sharp, but legal, practice and unfair manipulation. Different trading systems and cultures create different opportunities.

The EU has already established a clear principle that regulatory control should remain devolved to the member-states in the case of banking. Yet there is a stronger case for centralising the regulation of banks than there is for securities. A banking collapse within the euro-zone would almost invariably involve the European Central Bank. Although not formally recognised as the lender of last resort, the ECB may be required to inject liquidity into the euro-zone banking system or at least to tacitly approve government intervention. Furthermore, the banking sector is already subject to a far higher degree of international harmonisation than securities markets through international agreements such as the Basle accords. If the EU applies subsidiarity to the issue of banking regulation, it is hard to see why it should adopt the opposite approach for financial markets.

Some market proponents of a centralised European regulator, such as Deutsche Bank chairman Rolf Breuer, have responded to this anomaly by suggesting that the EU should create a single financial services agency, a European equivalent to the British Financial Services Authority. This body would oversee all financial services companies – including banking and insurance – and not just those parts of companies that are relevant to the securities markets. The German government's plan to create such a single

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regulatory institution – following the lead of Sweden and Britain amongst others – has bolstered hopes that a super-regulator could be replicated at the European level. Such a body might also help regulators to respond to the rapid consolidation within the financial services sector which is blurring the traditional differences between the banking, insurance and securities sectors. However, the establishment of such a vast and sprawling new institution would only make the problems of subsidiarity, accountability and legal harmonisation even more acute.

There is one final theoretical objection to the creation of the Euro SEC. A single body would diminish regulatory competition and thus innovation, an especially important quality in the rapidly evolving financial markets. It would also run against the grain of much current EU thinking. There is a growing belief in the virtues of "soft" mechanisms of reform – peer pressure, the sharing of best practice and the establishment of benchmarks. These measures allow progress towards common core standards but implicitly recognise the continued diversity in custom and practice of each country. Member-states can share the experience of successful innovations but adapt ideas to their own circumstances. A Euro SEC directly contravenes this devolved approach.

The battle over the Lamfalussy committee

The Lamfalussy committee of "wise men" was established in the summer of 2000 by the French presidency to investigate the future of EU securities regulation. The committee's vague mandate and its membership – drawn more from the regulatory authorities than the private sector – suggested that it would lean towards a comprehensive institutional solution.

The chairman, Baron Alexandre Lamfalussy, was previously head of the European Monetary Institute – the forerunner to the European Central Bank. Of the two private sector representatives, Norbert Walter, chief economist at Deutsche Bank, had already made plain his preference for a very broad ranging debate that included banking regulation and tax harmonisation. Even the respected British representative, Sir Nigel Wicks, had been closely involved in drawing up the euro's institutional framework as chairman of the Monetary Committee of senior treasury officials.

The distinguished members of the Lamfalussy committee were charged by European finance ministers with assessing how the "mechanism for

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regulating" securities in the EU could best respond to market developments. They were to propose reforms to "eliminate barriers and obstacles" and "ensure greater convergence and co-operation in day-to-day implementation".

French thinking behind the Lamfalussy committee reflected a preference for a radical institutional solution – if not the creation of a full-scale Euro SEC. French officials argued that Europe's fragmented financial markets were insufficiently attractive to foreign investors, and that diminished investment flows were consequently undermining the euro. Unlike other policy areas where economic reform may help to support the euro – in the labour markets for example – securities regulation poses few political difficulties for the French government. By implication, France was looking for a powerful new body to help restore some form of political control over the euro-zone's economic destiny.

French government thinking on securities market regulation is also coloured by the belief that consumer protection is as important as the removal of obstacles to market efficiency. This is partly a pragmatic response – the professional French market is considerably smaller than rival markets. But France, with German support, wants to focus on the "social" aspect of any financial markets reform.

In contrast, the British government is keen to prevent EU financial market regulation undermining competitiveness in financial services, a reflection of the City's importance to Britain's economy. That does not mean that the British Treasury ignores consumer issues. It has been pushing hard to make it easier for consumers to obtain cross-border redress. However, it is looking to protect not just private investors but all "end-users" – including major financial institutions, such as pension funds. Companies which raise capital are naturally concerned that over-restrictive regulation will force up their costs, damaging their competitiveness.

The battle over the withholding tax directive is a case in point. For the French and German governments, the proposed directive, which would have required all EU countries to impose a minimum tax on savings income, was aimed squarely at low-tax Luxembourg. A number of EU member-states failed to grasp that the directive might also force the London-based eurobond business to move outside the EU. In the end, the

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British succeeded in persuading other governments that, rather than setting a minimum taxation rate, EU tax authorities should exchange information on savings held within their territories.

This division can be clearly seen in the British reaction to the creation of the Lamfalussy committee. The British Treasury initially expressed scepticism about the need for the committee. However, once it became clear that other member-states wanted Lamfalussy to proceed, the Treasury was instrumental in changing the committee's terms of reference to ensure it was committed to assessing the impact of any new measures on market competitiveness.

Speeding up the regulatory process

Despite British fears, the Lamfalussy committee's work proved relatively uncontroversial. The committee's final report, published in mid-February 2001, reflects existing EU practice and has a distinctly pragmatic flavour. It focuses on developing the means to push through the objectives outlined at the Lisbon summit in March 2000 and in the Commission's Financial Services Action Plan, rather than on trying to fix a long-term institutional blue-print. EU leaders strongly endorsed the committee's conclusions at the Stockholm summit in March 2001.

There is much to commend in this approach. There is already a good degree of consensus about the policy objectives. These are:

★ the establishment of common prospectus rules to make it easier for firms to raise capital across Europe;

★ a clearer EU definition of a "professional" (sometimes referred to as a "sophisticated") investor, to permit securities traders to work more efficiently across borders;

★ the urgent overhaul of the Investment Services Directive to ensure that securities firms and exchanges can genuinely operate unimpeded across Europe, under the supervision of their home-country regulators.

The Lamfalussy committee calls for work on these priority areas to be completed by 2003, one year earlier than anticipated by the Financial

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Services Action Plan. However, even with broad agreement on policy goals, the prospects for swift progress are not encouraging. The battle over the takeover directive demonstrates many of the flaws in the current decision-making process (see box).

As a result, the Lamfalussy committee suggested that in future the EU should adopt a four-pronged approach to financial services regulation. Where primary legislation is required, the Commission and the Council of Ministers should concentrate on providing only framework agreements. A new European Securities Committee, consisting of senior national officials and Commission representatives, would fill in the technical details of the legislation and provide updates where necessary. A European Securities Regulators Committee – a successor body to the existing Forum of European Securities Commissions (FESCO) – would try to ensure that directives are coherently implemented at the national level and would advise on future legislation. Finally, the Commission would have responsibility for enforcement.

THE TAKEOVER DIRECTIVE

The 12-year saga of the Takeover Directive is a classic example of the problems inherent in the EU's current decision-making process. It is still not clear when the directive will finally become law. Yet some agreement on common minimum standards for the conduct of takeovers and mergers is vital in order to stimulate cross-border stock market activity and industrial restructuring in Europe. Unless investors are secure in the knowledge that they will have their interests protected in takeover situations, they will remain reluctant to build-up cross-border holdings.

The European Parliament's decision in December 2000 to pass an amendment, allowing companies that are subject to a takeover to take defensive action without consulting shareholders, has thrown the whole future of the directive into doubt. The Commission, the Council of Ministers and the Parliament must now go through a process of conciliation to try and resolve the dispute. So great is the gap between the Parliament and the other EU institutions, however, that it seems likely the Commission will be forced to start afresh – a process that would set back the directive by several years.

It is easy to understand why the legislation has proved controversial. Takeovers have until recently been highly political affairs. Governments have frequently intervened to protect national champions. A majority of EU countries has no tradition of hostile takeovers. A dispute between Britain

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and Spain over the status of Gibraltar has also held up progress. The takeover directive is designed to resolve these issues, removing politics from the process and providing a clear model for regulatory authorities in those countries with little experience of equity-based mergers and acquisitions.

The British government's approach has been ambiguous. On the one hand, British companies have frequently complained about the poor quality of takeover regimes in other European countries. They claim it is far easier for continental European companies to launch bids for UK-listed companies than vice versa. London-based financial institutions have also been unhappy about the lack of protection for minority shareholders in a number of EU markets.

On the other hand, UK takeover practitioners have been sniping almost continuously at the takeover directive, claiming that it will undermine British "light-touch" self-regulation. This is despite the fact that the directive itself is consciously modelled on practice in London.

This is not to say the legislation, even without the recent Parliamentary interference, is problem-free. It has many of the hallmarks of a classic political fudge. In particular, the question of which takeover authority should police a cross-border bid is not properly resolved. In the past, this has been a straightforward issue as companies are normally registered, and have their shares listed and traded under the same national rules. Now these three concepts are gradually becoming separated and it is perfectly possible for, say, an Austrian registered company – which could be the target of a bid from an Italian company – to be listed on Euronext but primarily traded through a German-based share-trading network.

EU governments determine when they should intervene in a cross-border bid in very different ways. In the UK, the Department of Trade and Industry becomes involved if the bid target is registered in Britain. In France, it is not the country of registration that is important, but whether the shares of the company under offer are traded in France.

The Takeover Directive as it currently stands has rather uncomfortably tried to permit both these methods of policing a bid. The fear is that the compromise will result in member-states squabbling over the right to intervene in a cross-border bid battle – and thus undermine recent efforts to depoliticise takeovers. Ironically, a separate Parliamentary amendment, seeking to clarify exactly which regulator would take the lead on cross-border bids, was rejected by MEPs. But the fact that the directive has a built-in review process suggests the EU is aware of the potential problems caused by this uneasy compromise. In the medium term, there should be just one test to determine under which jurisdiction a takeover bid falls. With increased cross-border share trading, a company's country of registration seems the most sensible option.

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The major institutional novelty in the Lamfalussy report is the creation of a powerful European Securities Committee (ESC). It would function under existing EU rules that allow certain implementation and review powers to be delegated to a committee overseen by the Commission – a procedure known as "comitology". The member-states proposed a similar committee following the passage of the Investment Services Directive in the mid-1990s. However, the proposal was shelved after concerted opposition from the European Parliament.

MEPs are again proving to be the major obstacle to the creation of a Securities Committee. Whereas the Parliament enjoys full co-decision powers on primary financial services legislation, it would have only limited supervisory powers over the new ESC. All "technical" amendments to fundamental single market legislation, such as the Investment Services Directive, would pass solely through the ESC in future. MEPs are worried that the Commission and the Council of Ministers may deliberately attempt to bypass the Parliament on important "political" issues by defining future legislation as "technical".

To try and forestall these criticisms, the Lamfalussy report recommended that the Council of Ministers, the Commission and the European Parliament should reach agreement on exactly what legislation can be passed to the Securities Committee. The report also suggested that the Parliament should be able to pass a non-binding resolution calling on the Commission to reconsider any measures taken by the ESC that may exceed its remit. MEPs, however, remain unconvinced of the virtues of this approach and have counter-proposed that they should have a binding right of appeal against the shifting of "technical" work to the Securities Committee.

Lamfalussy's attempt to reduce discreetly the role of MEPs in securities legislation is understandable. The Parliament's "amendment culture" has all too frequently slowed down or even derailed crucial legislation. The recent directive attempting to improve the single market in investment funds (known as UCITS in EU jargon) attracted no fewer than 200 amendments from MEPs. The Parliament may find that subjecting the work of a Securities Committee to thorough scrutiny, rather than trying to force through large numbers of technical amendments, will actually enhance the levels of EU transparency and accountability. MEPs should

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act as quality controllers for the new Committee. They should have the right to quiz members of the ESC and make public their conclusions. MEPs should also consider subjecting candidates for the Committee to "confirmation" hearings, in an effort to ensure that its members are of sufficient calibre.

The greatest weakness of the Lamfalussy plan is the unclear demarcation of powers between the various institutions. There is a danger that a new Securities Committee and the reinvention of FESCO as a formal European Securities Regulators Committee may actually increase the volume and complexity of legislation and encourage institutional competition. To be fair, it is not just the Parliament that suffers from an amendment culture. The new system could result in national governments – under pressure from industry or consumer groups – the Commission, the Securities Committee and the Regulators Committee all clamouring to have their concerns incorporated into legislation. While the Lamfalussy report recommends that all these EU institutions improve their consultation processes and increase transparency, the risk is that the extra layers of bureaucracy could make the system even more opaque.

The solution is to ensure the process works from the bottom-up rather than top-down. The new Regulators Committee will be close to the day-to-day realities of the markets, although it will need to improve on its own consultation mechanisms (see below). Apart from trying to ensure consistent implementation of agreed measures, the Regulators Committee will be best placed to indicate where existing legislation needs reform or where new European-level rules may be required. Acting on the advice of the Regulators Committee, the Securities Committee will be charged with amending existing legislation and preparing the groundwork for new regulations. While much of this work will be technical in nature, it is important that the European and national parliaments are given an opportunity to scrutinise both these new committees. The Council of Ministers should focus on the broadest enabling legislation in areas where new minimum European standards need to be agreed. The Commission will have an important role to play in encouraging dialogue between the Regulators Committee, the Securities Committee, and the other EU institutions, and also in ensuring that rules are coherently enforced across Europe.

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Enforcement and implementation

The value of a more efficient initial legislative process should not be overstated. It is arguably in the realms of enforcement and implementation that the greatest future gains can be made. The public consultation exercise carried out by the Lamfalussy committee bears out this point. Three-quarters of the respondents – securities firms and industry bodies – believe that EU securities legislation is neither transposed nor implemented consistently.

A more uniform application of the Investment Services Directive, for example, would have ensured that the EU was considerably closer to establishing a single market in equities. Even as the ISD was under discussion, the Italian government passed a law requiring foreign investment firms to incorporate Italian subsidiaries in order to access Italian financial markets. This was a glaring contravention of the "single passport" principle. Yet it was several years before action was brought against the Italian government. As the Financial Services Action Plan nears completion, the number of areas where improper implementation poses an obstacle to the integration of financial markets will only increase.

It is the European Commission that is responsible for ensuring single market rules are properly implemented. But it has traditionally focused on drafting legislation, with its brightest and most ambitious officials preferring to make policy rather than enforce it. Member-states are reluctant to increase the Commission's budget, leaving it with few extra resources to strengthen enforcement. As the Lamfalussy committee has noted, "barely a handful" of Commission staff are engaged in the complex and time-consuming, but essential, work of pursuing infringement cases. The procedures involve a series of formal warnings and then a lengthy "prosecution" in the European Court of Justice. In any case, financial services companies have brought few complaints about member-state behaviour to the Commission's attention.

The shift towards more inter-governmental means of policy-making in many areas of growing EU involvement – particularly in defence, police and judicial co-operation and economic co-ordination – has tended to sideline the Commission. But it still has a vital part to play in policing the single market, of which the financial services sector is set to become a central part.

There are a number of reasons why the Commission should be allowed to play this role. First, it is the sole guardian of the European interest, a status enshrined in the series of treaties and regulations that make up the *acquis communautaire*. Although the Commission has been guilty of a degree of political timidity in the past, a diminished legislative role should actually encourage a more independent approach to enforcement.

Stripping the Commission of securities enforcement – and handing the function to a Euro SEC – would also set an unfortunate precedent for other areas of the single market. If financial services had its own regulator, why not energy or telecoms? This would imply the creation of a series of expensive and cumbersome regulatory bodies scattered across Europe.

The Commission should also be able to guarantee a coherent approach to EU economic policy-making in general, if it continues to oversee single market enforcement. Single market infringement cases, for instance, often need to be pursued in tandem with competition investigations. The philosophical foundations of the single market are well established: common minimum standards transposed into law at the national level, combined with the mutual recognition of businesses under home country control (or the "single passport" principle).

The Commission is already well versed in these basic principles. It should ensure that national governments comply, not just with the letter of the law, but also with the spirit of the single market. The onus should be on governments to justify occasions where access has been denied to foreign businesses or where implementation deviates greatly from the European norm. In particular, there needs to be a thorough examination of member-state use of "general good" exemptions. These exemptions, designed to permit governments some flexibility on issues of national importance, are too often employed for protectionist rather than public interest purposes.

The improvement of the EU's record on implementation will require a thorough and regular review of existing legislation, and a more visible role for an "enforcement team" within the single market directorate. The Commission already produces an annual single market "scorecard". However, this tends to concentrate on the progress of directives as they wind their way through the EU institutions rather than on the problems posed by existing legislation. The Commission should be prepared to

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"name and shame" member-states which are unfairly restricting single market access. Given the importance of financial services to the single market, and to the success of the euro, it would seem sensible to devote a meeting of EU finance ministers each year to a discussion of a Commission review of implementation. Governments that hinder access would then be forced to justify their position to their "peers".

The Commission will also need to demonstrate a greater willingness to champion test cases in the Court, despite the strains in the EU's legal system. In future, it may be worth considering the creation of a fast-track legal enforcement procedure. The Commission should be able to win an injunction against member-state governments where there appears to be a clear case of a serious infringement of single market rules. It should have the right to levy an immediate fine – refundable only if the member-state wins the full European Court of Justice case. This would discourage some member-states from trying to "buy time" by deliberately dragging infringement cases through the European Court system. More businesses will approach the Commission with their own grievances if they are convinced that it will rigorously pursue their cause.

The enforcement process should also expose areas where it is the quality of the legislation, rather than its implementation that poses an obstacle to the single market. The challenge for the Commission will be to ensure that problems are tackled at the proper level. The bias should be to start from the bottom and work up. It should try to solve problems by pushing for a revision of the rules of conduct, a matter for FESCO (or the new Regulators Committee), or by amending existing legislation, rather than by rushing to introduce cumbersome new directives.

Competition

One area where the Commission already acts as a strong enforcer is competition policy. The EU's competition rules are the ultimate tool for the implementation and enforcement of the single market, once the basic ground-rules have been established through legislation. The use of competition policy becomes increasingly important as the single market matures.

The Commission has adopted a two-pronged strategy in areas where the single market is not yet complete. In postal services and energy, the single market directorate has concentrated on bringing forward liberalising

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legislation. Competition policy is then used as a further tool, both to try and force open markets and to ensure that large established players, especially state-owned companies, do not gain an unfair advantage while the single market rules are being developed. As a consequence, companies such as the (now part-privatised) Deutsche Post and Electricité de France have come under pressure for taking advantage of their domestic monopolies in order to expand abroad.

The Commission should adopt this approach to help speed-up the creation of a single market in equities. It must ensure no private sector – or government endorsed – practices pose a major obstacle to the efficient functioning of European stock markets. In a little-noted development at the end of 2000, France's supreme court ruled that the country's language rules (la loi Toubon) were applicable to stock market prospectuses. As a result, the Commission des Opérations des Bourses (COB) has now insisted that only prospectuses that are fully translated into French will be granted approval for marketing in France. The decision reverses guidelines that allowed companies seeking to interest French investors to supply only a summary in French. Over a third of all prospectuses issued in 2000 made use of the old language rules. The ruling will add to the costs of foreign firms seeking to raise capital in France and clearly run counter to EU efforts to simplify rules for cross-border prospectuses.

Mario Monti, the competition commissioner, has already shown an appetite for tackling unfair practices in the change-over to the euro. The Commission has undertaken a major investigation into the continuing high costs of euro-area currency transactions, including a series of "dawn raids" on a number of major European banks. It is conceivable that a similar investigation could be launched into the extra costs faced by retail traders attempting to deal in shares across borders. The Competition Directorate should also keep a close eye on whether financial institutions are guaranteed "fair and open" access to the clearing and settlement systems across Europe.

The Commission will also need to use its power to review mergers and acquisitions as stock exchange consolidation continues. Many of the mooted deals between exchanges are defensive in nature. Vigorous competition between exchanges is vital to ensure that investors and companies are provided with a cheap and efficient service.

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The Commission has understandably so far avoided entering the fray. Despite the volume of shares traded, exchanges are not huge businesses. OM, the Swedish exchange, was only willing to pay £900m for the London Stock Exchange and this included a substantial bid premium. Nor do the exchanges employ large numbers of people. Had the iX merger between London and Frankfurt been successful it would have created Europe's largest exchange, but with a mere 1,500 employees.

As a result, mergers of exchanges have fallen under the turnover threshold at which the Commission automatically intervenes. The Commission's scope for action may also be limited by the fact that member-state governments possess a public interest right to intervene in their domestic exchanges. Indeed, the Dutch government has reacted to the current round of merger activity by formally adopting new powers of intervention if any single institution acquires more than 10 per cent of the capital of any Netherlands-based exchange. Nevertheless, cross-border mergers and takeovers of exchanges will have a profound impact on the structure of the single market. The Commission must demand the right to intervene on competition grounds.

FESCO and the new European Regulators Committee

Although only three years old, the Forum of European Securities Commissions (FESCO) is already playing an important role in improving regulatory co-ordination across Europe. It employs the "soft" methods of integration – peer pressure, benchmarking and non-binding recommendations – to establish minimum standards across European markets and, in particular, to work out the rules of conduct required by EU legislation. A network rather than a formal group, FESCO possesses only a small secretariat and relies on senior members of the national regulatory bodies to lead working parties on particular areas of policy. The Commission is also present in an observer's role.

This informal structure of FESCO ensures that decisions are taken by the regulators that are close to the national markets and that there is sufficient flexibility in implementation. Many of these advantages could be lost if the mooted successor body to FESCO, the European Securities Regulators Committee, was formally brought within the legal apparatus of the EU.

However, there are a number of areas where the division of responsibilities

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requires greater clarity. Up to 50 separate regulatory bodies (40 within the EU itself) currently hold discussions through FESCO on different issues. Reaching mutual recognition agreements on issues such as cross-border enforcement is thus a painstaking task. And there are doubts about the ability of some bodies to implement FESCO agreements. Each government should therefore identify one "lead" representative to the new Regulators Committee and ensure that this body has the ability to enforce decisions.

The Lamfalussy group also suggested that the proposed Regulators Committee should reach decisions by qualified majority voting (QMV). Given that the new Committee will only be recommending legislation to other EU institutions, or agreeing non-binding rules of conduct for the implementation of existing rules, this appears a reasonable demand. In this context, QMV is not inconsistent with the "soft" measures of integration outlined above. However, members of the Committee must remain fully accountable to national parliaments and finance ministers for their decisions. FESCO, or the new Regulators Committee, should also begin to establish formal contact with the market regulators in the accession countries to ensure that they are also moving in the same direction.

If the Regulators Committee is going to play a major role in the EU legislative process it must also guard against the risk of excessive or inappropriate regulation. One of the principle private sector concerns about the work of FESCO has been a lack of transparency in decision-making. The Regulators Committee should aim to resolve this problem from its inception. It should draw up guidelines to ensure that the proportionality of any new rules is clearly established. It should publish a thorough assessment of their economic costs and benefits, and consider their impact on the competitiveness of European financial markets. The Committee should also establish formal methods for consultation with market participants and consumer groups. The Lamfalussy committee, which conducted interviews with a broad range of market participants and regulators both ahead of and after its preliminary report, has set a good precedent.

A role for self-regulation

Although it is important to improve the legal framework for European markets, the role of self-regulation should not be ignored. It can provide a swift and flexible means of establishing common minimum standards across European markets.

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Self-regulation of corporate governance, for instance, could help to side-step some of the problems of harmonising widely differing company law regimes. A number of European countries, including Britain, France and the Netherlands, have all recently introduced national self-regulatory codes for corporate governance.

[4] See La Porta, Lope-de-Silanes and Shleifer, "Corporate Ownership around the World", Journal of Finance, April 1999

The benefits of effective corporate governance cannot be overstated. Until investors are confident they enjoy some basic protection and receive full and transparent information, shares will carry an expensive risk premium. Recent economic research has demonstrated the role good corporate governance plays in guaranteeing diversity of ownership, high levels of liquidity and consequently a low cost of capital.[4] In the US more than half of quoted companies do not have one single owner with a stock holding greater than 5 per cent. In contrast, over 50 per cent of quoted companies in Austria, Belgium, Germany and Italy – where corporate governance principles are less developed – have a majority shareholder.

Some progress has already been made towards a European code of corporate governance. The European Association of Securities Dealers, for instance, has issued an extensive series of corporate governance guidelines. The private sector and academics are now combining to establish a European Corporate Governance Institute. However, the absence of powerful European financial services trade bodies has so far limited the implementation of corporate governance guidelines at the EU level. In Britain, for example, much of the work on corporate governance has been driven through by the major institutional investment groups such as the Association of British Insurers and the National Association of Pension Funds.

Some representatives from the major investment banks are gently floating the idea of a European body. This could be achieved by turning the European Securities Forum (ESF), which has so far concentrated its fire on developing pan-European clearing and settlement systems (see next chapter), into a body with a broader remit. However, the ESF's membership is currently restricted to only the largest financial institutions. The Commission has also quietly been trying to convince the private sector of the need for a "roundtable" of financial service industrialists. Any new body would have to be fully representative and recognise the needs of smaller brokers as well as the "bulge bracket" investment banks.

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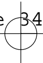
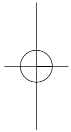
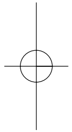
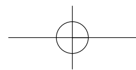
The inability of the major securities market players to establish a trade body reflects a certain reluctance by the major banks to enter the political arena. This is understandable, given the criticism levelled at the leading investment banks for their role in the attempted merger of iX (see next chapter). Yet without a strong European industry group, the financial services sector will continue to struggle to convince some governments of the need for reform. The big banks have long complained, in private, of the need to shake up the EU's decision-making process on financial services issues. A new trade-body would give effective voice to their concerns.

The establishment of a new trade body would also provide a means of exploring other areas that could be subjected to self-regulation, such as qualifications for professional investors. Establishing common standards across Europe would increase the already relatively high levels of cross-border mobility in the financial services sector and reassure consumers that their cross-border investments were in qualified hands. The Commission should also foster self-regulation. Acting as an honest broker, it should be able to bring political credibility to the process. It should help to galvanise the various trade organisations to reach agreement on issues such as common corporate governance standards, and to improve their representation at the European level.

3 Restructuring the markets

The 'Living Museums'[5]

If hard evidence were needed of the rapid changes occurring in Europe's equity markets, the fate of the London Stock Exchange (LSE) during the autumn of 2000 would be a natural starting point. That this august 200-year-old institution, by some distance the largest equity market in Europe, could find itself the bid target of a 20-year-old Swedish upstart, OM, would have been unthinkable a mere decade ago. Yet the LSE was simultaneously trying to finalise a once equally unimaginable merger with its Frankfurt counterpart, Deutsche Börse. Suddenly the LSE found itself in a corporate takeover battle familiar to any of the thousand companies listed on its market.

[5] The quotation comes from Olof Stenhammer, Chairman of OM

The failure of both the takeover bid and the merger demonstrate that stock exchanges are still far from being normal businesses. There is a wonderful paradox in the fact that stock exchanges – arguably the purest symbols of free-market capitalism – are often mutuals, governed by the needs of their members rather than the markets, protected from takeovers and resistant to change. Most of the established exchanges still have an explicit regulatory role. Even the LSE, which has recently shed both its mutual status and some of its regulatory functions, quickly found that its proposed merger was questioned as much for its political implications as for its underlying commercial strategy.

The LSE-Deutsche Börse tie-up, provisionally titled iX, pitched the small brokers and smaller company sector against the major investment houses and multinationals. For the major investment banks, the deal was about the creation of a huge liquid market, a cheap home for their ever-increasing cash piles. For the smaller players, it was both a threat to vested interests and an expensive and, arguably, unnecessary attempt to impose new technology. The structure of the deal initially paid little attention to the different needs of small companies or brokers.

Underneath these technical divisions lurked a surprising degree of

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xenophobia, whipped up by hostile elements in the press. The two exchanges made a major tactical mistake early on, suggesting that many British companies would in future choose to trade their shares in euros alone. This ignored the sensitivities of the euro debate within the UK, as well as the very real problems which British pension funds would face in meeting sterling liabilities if most of their equity trading was conducted in a different currency.

While this issue was quickly neutralised, political suspicions continued to cloud the deal. Some critics alleged that the iX deal would amount to a German takeover of the City. In London, the focus then turned to the role in brokering the deal played by a small cabal of American-owned investment banks, which were perceived as having the most to gain. There is a certain irony in the fact that often those who were most vociferous about the supposedly malign role being played by the US banks were the same people advocating that the LSE should ditch Frankfurt and team up with NASDAQ, the US market for high-growth stocks. The iX merger – and the OM bid – finally failed in the autumn of 2000, due chiefly to the scepticism of the London Exchange's members over the cost benefits of either deal. However, there is little doubt that the politicisation of the battle for control of the LSE made selling the iX deal in both London and Frankfurt that much more difficult.

From Euronext to Virt-x

While London and Frankfurt have fumbled their merger plans, other European markets have been more successful in their attempts to combine. Euronext, a three-way merger of the Paris, Amsterdam and Brussels markets is up and running. The new market lists around 1300 companies valued at €1.5 trillion, making it the second largest player in Europe.

In contrast to the huge technical, political and regulatory problems faced by iX, the Euronext merger has proceeded relatively smoothly. The new company is incorporated in the Netherlands, overseen by a 12-man supervisory board and a three-man executive management team. It aims to try and overcome regulatory obstacles by adopting a single set of listing rules, and it has a single clearing and settlement system available in Clearnet.

It is not just the established exchanges that are successfully joining forces. Tradepoint, London's infant exchange which has sought to attract

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institutional trading away from the London Stock Exchange, pulled off a major coup in the summer of 2000 when it unveiled a merger with the Zurich exchange. The new market, Virt-x, will trade major Swiss and EU stocks. Like Euronext, Virt-x intends to side step some of the regulatory problems faced by the iX merger by ensuring it is under the jurisdiction of just one regulator – the Financial Services Authority in London. The national Swiss market will continue to function in Zurich, subject to Swiss rules and regulation.

It should also be noted that OM itself has also recently launched a new market, Jiway, in alliance with Morgan Stanley, the US investment bank. While not an exchange in the traditional sense of the word – Jiway will have no listing or regulatory powers – the new trading platform will provide a single point of access for some 6000 European shares. The example of Jiway, which has chosen to be regulated as an exchange in London, suggests that the old divisions between exchange, trading platform and broker are rapidly breaking down.

Until recently, the exchange would both provide the forum for share transactions (a trading platform) and oversee the functioning of the market. Trading platforms were simply the infrastructure for dealing shares where brokers would buy and sell for their institutional and private clients. Now new competitors are able to offer cheap trading alternatives – commonly dubbed alternative trading systems (ATSs) – that are free of the regulatory burdens imposed on traditional exchanges. Major investment banks are also capable of transacting a substantial proportion of their share dealing on their own books, thereby reducing the need to access exchanges.

Global pressures

To a large extent, the machinations of European exchanges represent a reaction to global pressures. Chief among these has been the impact of technology. As recently as the 1980s an exchange was a physical entity, a place where traders would congregate to buy and sell shares on behalf of their clients or trade on their own account.

The New York Stock Exchange is now the only major exchange to preserve a trading floor. Elsewhere, the floor is now virtual. Computers route the orders, matching buy and sell bids. In theory, traders can now

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be located anywhere in the world and can connect with exchanges anywhere they wish.

This phenomenon has greatly enhanced competition in two ways. First, it has reduced the costs of trading. Some of the jobs associated with a trading floor, such as the pit runners – who carry orders from the trading floor to the back-office for approval – have simply disappeared. Other traditional functions have been cut back. In Europe, the market-makers – brokers who help maintain a market in a particular stock and profit from the difference between their buy and sell prices – are now largely restricted to dealing in smaller and less liquid stocks.

Technology has also lowered entry costs. In the last five years, there has been a huge growth in ATSs. But it is not just new arrivals that have tried to employ technology to gain a competitive advantage. In Europe, new technology has also greatly heightened competition between the existing markets. The LSE's successful attempt to win trading in European stocks in the late 1980s forced continental European exchanges to computerise. This drastically reduced their costs and helped ensure they regained the vast majority of the trading that had earlier been lost to London. This process is likely to intensify in the next couple of years, as the major players attempt to win the ultimate prize – to become the chief trading platform for Europe's top stocks.

A single exchange?

Cross-border share trading is too expensive in Europe. Merrill Lynch, the US investment bank, has calculated that the total costs of trading across the EU are around ten times higher than in the US. Clearly, the exchanges themselves can help to close that gap. In recent months, the focus has been on the potential for consolidation between European exchanges in order to reduce costs and improve the ease of cross-border trading. But even the exchanges would not exaggerate their own importance. Most of the gains from stock market mergers and takeovers are likely to be indirect: increasing the overall pool of liquidity and thus reducing the "spread" (the difference between the buy and sell price for a share); introducing new benchmark products; and driving regulatory reform.

Exchange users would benefit directly from a reduction in the number of trading systems. The LSE and the Deutsche Börse claimed that the iX

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merger would lead to savings of around £50 million per year. But there were also short-term costs. One of the reasons smaller broker firms opposed the iX merger was that the proposed compensation would not have covered the costs of installing the German Xetra trading system.

Despite these potential benefits, Europe would not be best served by the creation of a single stock market. Many of the improvements in exchange efficiency during the last decade have come from competition among the major stock markets. As has already been noted, there is a clear link between the launch of the London Stock Exchange's SEAQ I system in the late 1980s and the overhaul of the continental bourses. Frankfurt and Paris, in particular, were forced to modernise their systems, in turn obliging London to reappraise its strategy.

The rise of Alternative Trading Systems, which provide a variety of trading techniques currently unavailable on the major exchanges, has also forced the established exchanges to examine how they can improve their services. Most recently, this has encouraged exchanges to demutualise and to broaden their ownership base beyond the broking companies, which have a vested interest in trying to keep costs high and in limiting exchange access. Ownership is open to other exchange users such as pensions funds and even listed companies. While this process is far from complete, the recent flotations of the LSE and Deutsche Börse, and the forthcoming flotation of Euronext, have modernised the governance structure of these exchanges.

As Figure 4 demonstrates, the gap in trading costs between Europe and the US is now relatively narrow. The two major American exchanges continue to benefit from low commission rates, due to high share turnover and intense competition amongst brokers. However, Europe has stolen a lead in terms of market impact – a measure of trading efficiency. Market impact is the difference between the price at which a stock trade is actually executed and the average price of that share during the day's trading. This gap tends to widen during major share purchases. Heavy demand for a particular share naturally forces up prices – especially when the market makers get wind of a major deal. However, most European exchanges, which employ a quote-driven auction system, have been able to minimise this extra cost by curtailing the role of market-makers. The higher total cost level in Britain is due to stamp duty paid on share purchases.

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FIGURE 4: TRADING COSTS IN SELECTED EXCHANGES

In basis points	*Broker commission*	*Exchange fees**	*Market impact*	*Total cost 2Q 2000*	*Total cost 1997*
France	21.84	1.49	4.94	28.24	26.7
Germany	21.14	1.29	5.14	27.57	33.3
Italy	22.57	0.94	8.79	32.3	29.7
Netherlands	20.5	1.38	4.02	25.9	25.8
UK-buys	17.85	48.72	5.92	72.49	75.1
UK-sells	16.82	0.55	17.24	34.61	30.1
US-NYSE	13.43	0.54	12.8	26.77	31.5
US-NASDAQ	2.04	0.46	33.16	35.66	39.0
Japan	15.48	0	9.59	25.07	30.02

**Including stamp duty*

SOURCE: ELKINS/MCSHERRY

Technology also makes the concept of a single exchange redundant. When exchanges operated through open outcry systems – traders literally shouting orders and prices at one another – it was vital to have a single physical location. Now most exchanges are virtual creatures with access to the market theoretically available from anywhere in the world. Rather than seeking a single exchange, a better goal would be to increase the technological compatibility between the various trading systems, so that investors can seek out the best price at a minimum cost. Specialist software companies, such as Royal Blue, are already offering systems capable of seeking out the best possible trades across the major markets and main Alternative Trading Systems.

The dangers of fragmentation

There is, of course, a downside to increased competition between exchanges: the risk of market fragmentation. If trading is split between too many markets, liquidity levels will decline, leading to widening spreads between the bid and offer prices for shares and thus higher costs.

In recent years, this has been a particular concern of the US Securities and

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Exchange Commission (SEC), where a series of new Alternative Trading Systems have managed to lure sizeable chunks of trading away from the established New York Stock Exchange (NYSE) and NASDAQ. In 2000, new entrants such as Instinet and Posit had taken nearly a third of the volume of trading from NASDAQ and around 5 per cent from the NYSE.

This trend has been fuelled by the development of cheap new technology. It currently costs around $10 million to establish an ATS capable of handling 15 share-dealing transactions per second. ATSs have attracted business by offering services that the established exchanges do not. In particular, they often provide full trade anonymity, and that is especially attractive to the major financial institutions since it greatly reduces the market impact costs of large trades.

In Europe, the impact of new entrants has been less dramatic, although there are now around 20 ATSs operating, primarily in Britain and Germany. In part, this reflects the fact that most European exchanges are more technologically advanced than the NYSE and NASDAQ and offer more open membership. The NYSE still uses a human trading floor while NASDAQ, although computerised, routes orders through market-makers. But it should also be remembered that Europe remains in many ways a highly fragmented market. There are still some 30 established exchanges employing 10 incompatible trading systems across the EU.

As a result, European regulators have to date taken a more *laissez faire* approach to the rise of ATSs, whereas the SEC has introduced new rules obliging Alternative Trading Systems to submit to increasing levels of regulation as their market share rises. A FESCO working party has recently completed a major examination of this issue. FESCO's immediate conclusion is that EU regulators should monitor the situation rather than rush to issue new regulations.

There are good reasons to believe that a liquidity crisis can be avoided, despite the growth of ATSs. Exchanges are networks. Their utility increases with the number of users. It is ultimately not in the interest of either ATSs or traditional exchange users to fragment markets and consequently send costs soaring. The initial success of ATSs has, of course, been down to the fact that by providing niche services they have been able to offer narrower spreads and lower transaction costs. Most ATSs are

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dependent on established exchanges for their survival. They rely on the information provided by the main exchange and, in particular, its pricing data to form their own price levels. In effect they are “parasites” and to be successful accept the need for co-existence with exchanges.

Technology is also likely to reduce the disadvantages of fragmented markets. Intelligent software will hunt out the best prices across a variety of markets. Traders will use their systems to arbitrage, seeking out small differentials in price between markets to turn a profit. In effect, technology will recreate a single trading floor even in a more fragmented market. Even retail investors should be able to take advantage of this, routing orders through the major brokers for the best price.

However, there are a number of issues involved in the rise of ATSs which are likely to require new regulation in the medium term. In particular, there is the debate about the required level of trade transparency. If the purchaser can conceal their identity and size of trade, they are more likely to achieve smaller price spreads. In Germany, for instance, a huge proportion of share trading actually takes place off-exchange (or “over the counter”), as financial institutions are only obliged to reveal trade details to the regulators and not to the markets.

The SEC, however, has tended to push for maximum transparency, arguing that it creates a level playing field between large and small traders, who are normally not able to access over-the-counter trading facilities. The industry itself is divided on this issue. One senior banker wryly remarked that all traders prefer full transparency except in the case of their own trades. There needs to be sufficient trade transparency to ensure that all investors can access share prices which are representative of trading in the market as a whole. This does not imply full pre-trade transparency but suggests that ATSs must be prepared to supply their post-trade prices to the market.

The other key issue is the relationship between the new entrants and the existing exchanges. One of the reasons ATSs have been able to provide cheaper services is that they have none of the standard regulatory functions of exchanges. Instead, they have generally operated under the less onerous regulatory regime enjoyed by securities firms, which means for instance that there is no obligation to provide price information to the

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wider market. In Europe, the Investment Services Directive requires that only stock markets which provide listing functions can be classified as an "exchange". That means that most ATSs have no choice but to be regulated as securities firms.

The EU will need to revise this outdated definition in order to restore a level playing field. It seems possible that more established exchanges will follow the LSE's lead and hand back regulatory functions, such as share listing rules, to the national regulator. Equally, regulators should expect ATSs to fulfil minimum requirements, such as a reasonable level of price transparency, sufficiently open access to ensure users can deal at a fair price, and the monitoring of trades for regulatory purposes. The latter is especially important, since a proliferation of trading systems will increase the risks of market manipulation.

A threat to smaller stocks

Another reason why a single exchange should be avoided is that it would be bad for smaller stocks. The main interest of the major exchanges is the lucrative trade in blue chips and growth stocks, especially technology companies. Smaller stocks have often been neglected.

The proposed iX merger ignored smaller stocks, the two exchanges even describing those shares that would not qualify for the London blue chip or Frankfurt-based growth markets as the "rump". Smaller companies are rightly worried that money will naturally flow to the heavily marketed, glamorous stocks, bequeathing their shares wide spreads and poor ratings. The massive growth in institutional funds is also a problem as the larger funds simply cannot deal in the lower liquidity levels offered by smaller stocks.

There will inevitably be losers in the battle for the premium stocks. Some exchanges could instead decide to create niche markets in the less fashionable sectors. This would pool liquidity in these stocks. It would also provide a clear focus for analyst teams, which can help to promote intelligent appraisals of individual sectors but risk being culled when the sector declines beyond a certain size on any one exchange.

Unloved companies could otherwise emphasise their regional identity. Even in the US, a surprisingly large proportion of shareholders are located

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in the same region as the company's operations. Investors feel more comfortable with a physical understanding of the business. The internet allows companies to market their shares efficiently to a regional audience. However, this process will need to be supported by exchanges that are dedicated to promoting all their listed companies.

Blocked pipes: the vital role of clearing and settlement

The largest costs of dealing in shares cross-border lie not in the inefficiency of European exchanges, but in the fragmentation of clearing and settlement companies. This is where the "back-office" task of paying for shares and transferring the necessary paperwork (albeit largely electronically) is undertaken.

Here the American markets have a clear advantage. All equity trading clearing and settlement is now carried out through just one company: the US Depository Trust and Clearing Corporation. In contrast, there are 26 settlement systems within the EU. It requires around 650 bilateral links between the various clearing and settlement companies to ensure full cross-border trading in Europe. This is not just a slow and cumbersome procedure, but it also leaves cross-border settlement more vulnerable to risks such as systems breakdown.

Of the extra costs incurred trading European shares, an estimated 80 per cent derive from this fractured clearing and settlement system. In the US there are one trillion equity transactions a year, compared with 210 billion in Europe. Yet the direct costs of trading are around $580 million compared with more than $1 billion in Europe (see figure 5). However, the potential savings in Europe should be far greater than even this figure. Securities firms and banks would be able to reduce the amount of capital needed to meet regulatory requirements if there were fewer clearing and settlement organisations.

For the major financial institutions there are large potential savings in the creation of a secure central counter-party. Operated by the clearing and settlement company, a central counter-party acts as "the buyer for all sellers and a seller for all buyers" – consequently assuming the risk for all payments. It allows institutions to "net" their trades. This means that rather than transferring sums for each individual trade, a financial company simply settles the outstanding balance at the end of the day –

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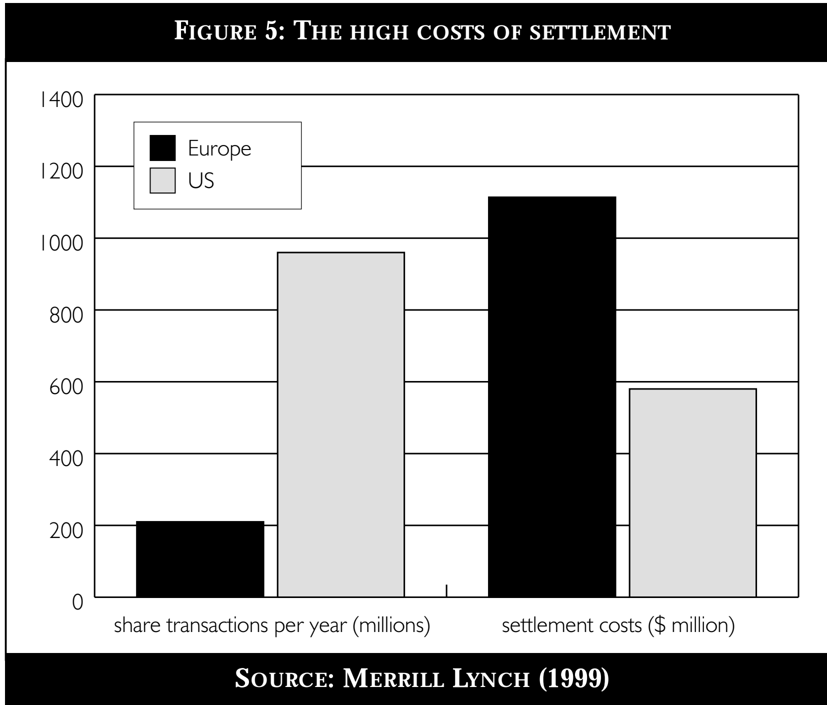
FIGURE 5: THE HIGH COSTS OF SETTLEMENT



SOURCE: MERRILL LYNCH (1999)

greatly reducing the number of transactions along with the amount of capital that needs to flow through the settlement process. It also makes it easier for major institutions to undertake anonymous trades, for the central party guarantee means there is no need to identify the co-respondent of each trade. This helps to reduce the market impact costs of large trades.

The European Securities Forum strongly believes that clearing and settlement represents something of a natural monopoly. The Forum argues that the mutual nature of the business means that it would be better restructured along mutual lines, ideally with the ultimate creation of just one pan-European clearing organisation. It is ironic that just as the exchanges are demutualising, the clearing and settlement companies should be encouraged to do the opposite. As an area where innovations in technology and risk management may yield future efficiencies, it is not entirely clear why the rules of competition should be entirely suspended. However, there are undoubtedly far too many expensive clearing and settlement systems.

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The Forum has targeted the two international securities clearing depositories – Euroclear and Cedel – as early targets for a merger. But its hopes of persuading Europe's clearing and settlement houses to merge have so far been in vain. Inevitably, there is a series of major obstacles to consolidation within the sector. Clearing and settlement is often vertically integrated with the exchanges themselves. It is a profitable business and so there has been no great incentive for exchanges to separate the functions. In the iX deal, Clearstream, Deutsche Börse's clearing arm, was actually left outside the merger terms for it would have made the German company much bigger than the LSE, which does not own the London Clearing House, the UK's equivalent to Clearstream.

Both Deutsche Börse and Euronext have made it clear that they intend to hold onto their respective clearing and settlement companies after their own stock market flotations. Given that these subsidiaries provide a substantial proportion of the overall profits of the two companies, the two exchanges will be unwilling to relinquish control. The stance of the European Securities Forum has not been helped by the fact that its chief supporters – the major investment banks – pick up substantial fees from advising these exchanges to float with their settlement houses intact. Outside intervention may therefore be needed to stimulate reform. The Commission should consider using its competition powers to speed up the separation of exchanges and the clearing and settlement facilities across Europe – or at the very least to ensure that the nationally based clearing and settlement companies are offering fair and open access. The Giovannini Group, a committee of market participants that advises the Commission on economic and financial matters, began looking at these very issues in the spring of 2001.

Consolidation will also raise the question of who should act as regulator. Until now this has not been an issue, since each member-state has its own clearing and settlement system. However, widespread consolidation could leave just one or two organisations responsible for guaranteeing that all transactions in the European equity and bond markets are completed quickly and efficiently. The sums for which these organisations could be responsible would be mind-boggling: Euroclear alone already handles 140,000 trades a day, worth on average $240 billion.

In the past some regulators, most notably the Bank of England, have

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expressed reservations about permitting clearing and settlement companies to become central counter-parties. There is a danger that the assumption of settlement risk by a central counter-party may actually encourage banks to make poor investment decisions – a process referred to by economists as "moral hazard". If securities firms believe that the central counter-party system will be responsible for any failed payments, the temptation to take on riskier trades may be greater.

But these risks should not be exaggerated. A more coherent clearing and settlement system should actually diminish the possibility of a major failure. A well-managed central counter-party would reduce the risk of default. The risk is transferred to the clearing and settlement house rather than spread around hundreds of financial companies. There are also ways of structuring the counter-party agreements to side-step the problems of moral hazard. Institutions that take advantage of the counter-party system are expected to provide an initial deposit and to bear part of the losses in the event of a major default. That should ensure it would still be in the interests of all members to maintain their own effective risk management systems.

The clearing and settlement houses are also under heavy pressure to reduce the settlement period for trades. As well as helping to reduce costs, this would help to decrease the risk of a party defaulting in the period between trade and settlement.

Indeed, central banks seem to be coming round to the idea that a well-managed central counter-party system would improve financial stability, and they are examining more seriously their role in regulating clearing houses.[6] The sums involved make it almost inevitable that it would be the central banks rather than the securities commissions – which cannot inject short-term liquidity into the system in the event of a crisis – that would ultimately have to act.

A number of the clearing and settlement houses are already regulated as banks. Euroclear is monitored by the banking regulator in Belgium, although with so much of its business originating in London, the Financial Services Authority also takes an interest. This pragmatic approach to regulation seems the most sensible way forward, ensuring Euroclear is linked both to the euro-zone regulatory

[6] See, for instance, "Central counter-party clearing houses and financial stability", Bank Of England Financial Stability Review, June 1999. In early 2001, the London Clearing House, London Stock Exchange and Crest settlement system unveiled plans to launch a central counter-party for the London market

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system – and indirectly the European Central Bank – as well as to London.

Some regulation will still have to be carried out at EU level. In particular, the EU needs to reach agreement on what is suitable as collateral for central counter-party agreements. The issue of what to do in the event of a bankruptcy must also be considered. At present there is legal uncertainty across Europe about exactly when contracts, including share trades, become invalid due to bankruptcy. A Settlement Finality Directive, which should help to alleviate this problem by fixing common rules for contract settlement in the event of bankruptcy, has been agreed – but is not yet implemented in all EU member-states.

The Lamfalussy report also called on the EU to consider some pan-European guidelines for the regulation of clearing and settlement activities. As cross-border securities trading increases in the EU, it appears inevitable that some common regulatory guidelines will need to be established. Lax regulation in one EU market could pose a risk to European securities markets as a whole. However, just as the core banking standards are established at the global level, clearing and settlement regulation is as much an international as an European problem. The Group of 30 financial markets think-tank embarked in March 2001 on an examination of clearing and settlement issues at the global level. The EU should heed its conclusions.

This is also an area where Britain needs to take action at a domestic level. The plans to merge London Clearing House and Crest into a single entity will take some of the costs out of the existing system. However, UK costs remain unnecessarily high, because of the continuing right of shareholders to hold paper evidence of share ownership. In recent years this has turned major flotations into an expensive logistical operation. The Halifax, for instance, was forced to warehouse tonnes of paper certificates for its members when this once mutually-owned bank came to the market. It is time for Britain to catch up with continental European practice and make electronic ownership the norm.

4 The global context

A global stock market?

The debate about the future of financial markets within the EU has so far concentrated on the potential for integration of European markets. But should the ultimate goal not be the creation of a single global exchange?

There is a case for the creation of a single market in blue chips – a kind of Globalstox 100. The major securities firms, which dominate international equity trading, are global in reach. Similarly, the largest quoted companies are also truly multinational and would like their shareholder base to reflect that fact. At the moment, their only option is the rather expensive and complicated route of establishing dual or even multi-listings on different exchanges. Retail investors are also increasingly excited by the idea of truly international stocks. In the last few years, there has been rapid growth in sales of flagship "global champion" investment funds – those which seek to invest in international blue-chip stocks on both sides of the Atlantic.

The exchanges themselves have responded to this demand by planning international alliances. The aim is to try and establish a network of markets to ensure the seamless, 24-hour trading of major multinational stocks. NASDAQ has been particularly active, linking with a number of potential partners within Europe and the Far East, although concrete progress has been limited. Having failed to establish its own market in Europe, NASDAQ courted iX until the collapse of the merger. The US exchange then turned to the London Stock Exchange in an effort to establish a European presence. The LSE, however, chastened by the iX debacle, has so far insisted on remaining independent. Rebuffed once again, NASDAQ has now linked up with the Brussels-based EASDAQ exchange.

Aside from the potential political difficulties, there are also practical limits to the creation of a truly global stock market. The problems of agreeing common regulatory and accounting standards would be even more difficult

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to resolve than in Europe. Although there has been some progress towards establishing basic international accounting standards, the SEC insists on using its own accounting rules, the US GAAP. Accounting differences can have a profound impact on a company's results, and consequently influence its business strategy. Regulators have now established a web of bilateral understandings (see below), principally for cross-border trade monitoring purposes, but they are a long way from agreeing on minimum international standards. The SEC, in particular, is reluctant to see its powers to regulate US investors and companies diminished.

Companies will also still need an exchange as a single outlet for providing information. Managers need to brief analysts (and journalists) on their company's progress. It is physically impossible to provide a full results briefing in more than one place. The exchanges seem to have recognised many of the difficulties inherent in creating a global exchange – hence the focus on competing alliances. Their goal is to establish benchmark global indices that permit 24-hour trading in individual stocks, rather than integrated exchanges.

Nor will the advent of global trading in major companies mark the demise of the regional stock markets. As noted above, smaller companies – and in a global context this is going to be a very broad definition – will remain reliant on their local exchanges to help market their potential to the wider public.

Promoting international competition

Contrary to common perceptions, the EU permits far greater international competition between exchanges than the US. While American markets are free to install their screens in Europe, and to advertise directly to private investors to help raise brand awareness – a strategy most notably employed by NASDAQ – there is no reciprocity. Any European exchange would have to move its holding company to the US and make sure that all firms quoted on its markets complied with US accounting and listing rules.

The EU should make the liberalisation of rules governing the operation of exchanges a key part of future World Trade Organisation negotiations over trade in services. If the European exchanges are going to be able to compete for the global benchmark indices outlined above, they are going to have to be able to operate in the US.

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There are some grounds for optimism on this score. The US derivatives regulator has now permitted the two major European operators, Liffe and Eurex, to place screens on US territory. The SEC has also hinted that it is willing to consider a partial liberalisation, although its concern to protect retail investors means that it is reluctant to do so. And, as one Commission official noted, the EU's relative openness may actually prove a disadvantage as it leaves the European side with fewer bargaining chips. The US will invariably link concessions in this area with gains elsewhere in full-scale trade negotiations.

Supporting IOSCO

As part of the push for the liberalisation of exchanges, the EU should attempt to bolster the role of the International Organisation of Securities Commissions (IOSCO). IOSCO is already an important member of the new Group of Seven Financial Stability Forum. The forum, which was established in response to the Asian financial crisis of 1997-8, brings together IOSCO, the Basle banking supervisory committee and the International Association of Insurance Supervisors with the IMF, World Bank and G7 representatives. Its ambition is to improve market and regulatory transparency and to act as an early warning system for future crises.

IOSCO would function better if it regularly employed the methods of co-ordination used by FESCO, such as peer review and exchange of best practice. At present however, most countries employ bilateral memoranda, rather than adopting a multilateral approach through IOSCO. The FSA in Britain, for example, has signed over 100 such agreements. IOSCO's influence has suffered as a result. The national regulators are thus reluctant to commit sufficient resources to IOSCO projects and are wary of criticising fellow members.

IOSCO's reach is also limited by the desire of many national regulators to maintain full control over their citizens' behaviour, even where this implies extra-territorial jurisdiction. The SEC, in particular, has been ruthless in ensuring that its own laws are applied as widely as possible. Europe is affected by the SEC's desire that accountancy firms should not supply auditing and consultancy services to the same client. In this context, using IOSCO to pursue multilateral minimum standards, in areas such as the cross-selling of consultancy services by

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auditing firms, could actually help to protect the independence of most national regulators.

EU regulators should use their experience of reaching common positions in FESCO to improve their effectiveness in dealings with IOSCO. The EU regulators should be able to pursue a single line at IOSCO on issues that have already been agreed at the European level. The combined power of the EU regulators would greatly increase the chances of reaching multilateral rather than bilateral agreements. Such is the power of the SEC, however, that it is clearly going to take a concerted effort by EU regulators to improve on multilateral arrangements.

A word of caution

This pamphlet has been completed at a time when global stock prices are tumbling. However, the fallout from this market turmoil has not yet had much impact at a political level, where there remains at least some basic understanding that efficient and transparent markets are pivotal to modern economies (notwithstanding vigorous disagreements over the priorities for regulatory reform).

There is some truth in the claims that stock markets in developed economies have become thoroughly depoliticised. The debate over the Euro SEC aside, most of the current EU approach to reform is technical rather than political. However, politics continues to lurk just below the surface. Equity markets remain important instruments of national economic policy. For the last two decades, governments have employed the equity markets to help with privatisations and to ease the burden on state finances by the development of private pension funds. Equity trading is also an increasingly important source of tax. As stock markets grow and more private investors purchase shares and unit trusts, governments are benefiting from higher capital gains tax revenue and in some countries, such as the UK, from stamp duty on share purchases.

It is perfectly feasible, however, that as in Asia during the 1997-8 financial crisis, equity markets could become politicised once more. The collapse in Asian currency and securities markets provoked a backlash in a number of countries. In particular, Malaysia reintroduced capital controls, making it difficult for overseas investors to dispose of their shareholdings. The Malaysian government claimed that “speculators” had caused the market collapse in the first place.

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The great 1990s bull run in western markets is clearly over. The question now is whether the prospect of a serious economic slowdown in the United States will cast a longer term shadow over the equity markets. If stock market losses continue to mount and some firms begin to fail, public and thus political opinion may shift decisively against the markets. For the moment, however, public disquiet appears to have been confined to the collapse of stocks in the over-hyped and overvalued technology, media and telecoms sectors.

Politicians and businesses are already facing a stern challenge from anti-globalisation campaigners. While most of the fire has so far been targeted at the multinationals and the WTO, London's Square Mile has become a regular focus for anti-capitalist demonstrators. The stand-off between Swiss police and protestors at the World Economic Forum in Davos is also becoming an annual event.

In the event of a prolonged economic downturn, the markets are likely to be seen as the cause rather than the messengers of financial difficulties. There is already widespread concern that politicians have no choice but to acquiesce in an economic orthodoxy dictated by the markets.[7]

In this context, it is imperative that Europe's politicians realise that the case for equity markets cannot be taken for granted and must constantly be remade. Business leaders and the European Commission are privately concerned that some European governments could become lukewarm on the need to push forward the Lisbon agenda, including those reforms targeted at the financial markets. Unseemly rows over the pace of reform in Europe may, in themselves, begin to turn public opinion against the markets.

[7] For a robust defence of the market as messenger see Rolf Breuer, "Politics in the 21st century: in the tow of financial markets", Deutsche Bank Bulletin, 2000

The limits to reform

Nor does the agenda outlined in this pamphlet represent a panacea. There are important limits to the reform process. An equity security is by nature a legal construct but legal practices differ hugely across the 15 member-states. Equity markets remain intimately bound up with national tax and social security systems. At the moment, taxes on capital gains and dividend income are treated in different ways across the EU. Private pension provision levels vary widely. Governments offer a variety of tax breaks on

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equity fund investments. In Britain there is a higher level of stamp duty. All these different factors inevitably contribute to variations in investor behaviour from country to country.

This is borne out by the initial responses to the Lamfalussy report. These stressed that different legal traditions, tax differences and cultural and linguistic problems were also major barriers to an integrated stock market. A recent report has demonstrated just how large a role these cultural and linguistic factors can play within the market.[8] The author examined the profitability of traders using the Xetra system in Frankfurt and concluded that German-speaking traders recorded significantly better profit records than their international counterparts. However, it was not geographical location *per se* which proved important. German-speaking traders in Austria and Switzerland were just as successful as their counterparts in Frankfurt. The message is that linguistic and cultural insiders are best able to employ market information to profitable advantage.

[8] See Harald Hau, "Information and geography: evidence from the German Stock Market", CEPR Discussion Paper 2297, November 1999

The global nature of international equity markets already imposes a certain discipline on governments. Business will simply migrate elsewhere if the obstacles to profitable trading are too high. If investors find the levels of UK stamp duty unacceptable, the British government will have little choice but to reduce the taxation level. Markets such as Frankfurt are already trying to increase their international presence through a greater use of the English language. The EU is also capable of playing a positive role in encouraging greater cross-border trading, and in improving the overall competitiveness of European equity markets. However, Europe cannot expect to replicate the US model exactly. While the EU is right to want to close the growth gap with the US, it should focus on developing its own distinctive equity-based future.

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Summary of conclusions

★ The European Commission should undertake research to demonstrate the importance of equity markets to economic growth rates and the creation of new businesses. This is vital to underpin the intellectual case for reform in the European markets.

★ The creation of a Euro SEC, or more ambitiously, an integrated European financial services regulator, is a seductively simple idea. However, it ignores the clear case for subsidiarity in the regulation of financial markets and the need to ensure maximum accountability.

★ The Lamfalussy committee has provided a welcome analysis of how the EU legislative process can be accelerated. However, the proposed demarcation between the various institutions – the Council of Ministers, the Commission, the Securities Committee and the European Regulators Committee – will need to be clarified. The bias should be towards a bottom up rather than top down process, with the Regulators Committee not only providing grass-roots implementation but also indicating where legislative reform is needed. The Securities Committee should focus only on areas where European enabling legislation is required, in particular those areas outlined in the Financial Services Action Plan.

★ The European Parliament should subject the work of the proposed Securities Committee to thorough scrutiny. MEPs should act as "quality controllers", with the right to quiz members of the committee and make public their conclusions. MEPs should also consider subjecting candidates for the Securities Committee to "confirmation" hearings, in an effort to ensure that its members are of sufficient calibre.

★ The Commission needs to take its enforcement role for financial services legislation more seriously. It should consider creating a stronger and more visible "enforcement" team within the internal

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market directorate. An EcoFin meeting each year should be devoted to the discussion of financial services implementation; governments which are hindering access should be made to justify their position to their peers.

★ The Commission should show a greater willingness to pursue infringement cases through the European Court of Justice. This would encourage the private sector, in particular, to bring forward its complaints. In the medium term, the Commission should consider campaigning for a "fast-track" enforcement procedure.

★ The Commission will in future need to employ its competition powers to ensure the efficient functioning of the single market in securities. It should be willing to ensure there is "fair and open" access to clearing and settlement systems and exchanges. The Commission should also aim to ensure that its ability to scrutinise cross-border mergers of exchanges – which will have clear single market implications – is not infringed by the right of member-state governments to intervene on grounds of public interest.

★ The European Regulators Committee, the likely successor body to the Forum of European Securities Commissions (FESCO), has an evolving role to play in developing a coherent single market in securities. It should continue to use "soft" methods such as non-binding recommendations and peer pressure to ensure the consistent, but flexible, application of EU legislation. However, it will need to designate one "lead" regulator from each member-state and to ensure that this body can implement the committee agreements – while remaining accountable to national parliaments and governments.

★ The Regulators Committee should develop guidelines that oblige it to consider issues of proportionality and to undertake appropriate cost and benefit analysis when developing new rules. It should also establish clear consultation procedures.

★ Financial companies, with the support of the Commission, should explore the possibility of establishing pan-European voluntary

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standards in policy areas where self-regulation is the established norm, such as corporate governance. The securities industry needs to establish a powerful, but inclusive, trade body to help maintain the impetus for reform.

★ A single European exchange would bring limited cost savings. In the last decade it has been competition between rather than consolidation of exchanges that has driven costs lower. Network technology has the potential to make exchange mergers unnecessary.

★ The rise of Alternative Trading Systems does present new challenges. Regulators will need to ensure that there is a level playing field between new entrants and existing exchanges. However, the experience to date does not suggest that ATSs pose a major threat to the integrity of European markets. As a spur to competition, ATSs may even improve overall trading efficiency.

★ Consolidation in the clearing and settlement sector would help to reduce drastically cross-border trading costs across Europe. However, progress appears unlikely as long as many clearing and settlement houses are still owned by exchanges. The Commission needs to explore whether it can use its competition powers to force a reduction in costs, and in particular to encourage the exchanges to spin off their clearing subsidiaries.

★ The EU should make the liberalisation of rules governing the operation of exchanges a key part of future WTO negotiations. At the moment European exchanges are unfairly discriminated against, because they cannot advertise to US investors or even offer them direct access to European markets. In contrast, US markets are allowed full access in Europe – a course of action most successfully employed by NASDAQ.

★ The EU should also offer greater support to the International Organisation of Securities Commissions (IOSCO). It should encourage FESCO members to adopt a common EU position at IOSCO meetings. The combined weight of EU regulators could make it easier for IOSCO to forge multilateral agreements.

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- The changing global economic climate does not reduce the need for further integration in European financial markets. But it does mean that European governments will steadfastly need to make the case for reform – or risk ceding ground to the wide range of anti-globalisation groups.

- Europe cannot expect to replicate all the favourable conditions that have nurtured dynamic equity markets in the United States. Equities are a legal construct, intimately bound up with the legal and political culture of a country. This will mean that some inconsistencies between national markets will inevitably persist. But this need not and should not undermine the basic case for a single market in European equities.