

COMPETITION COMMISSION



# The economic analysis in the LSE/Deutsche Börse/Euronext merger inquiry

Nicola Mazzarotto\*, Economic Adviser

ACE Conference

Mannheim 30/11/2006

\*The views expressed here are my own and do not necessarily reflect the views of the Competition Commission or of any of its members.

# COMPETITION COMMISSION



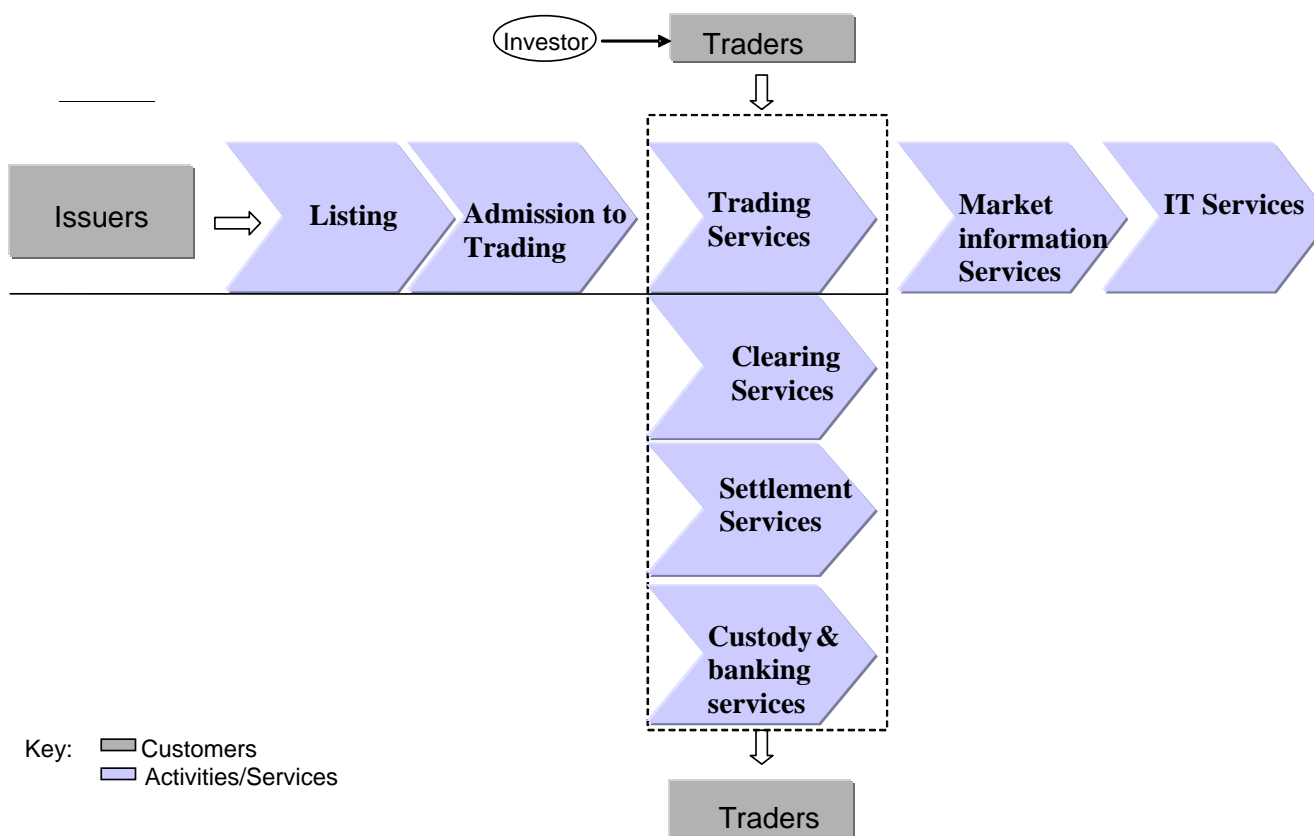
## Overview

1. Introduction
2. Competition in trading services
3. Market definition
4. SLC finding
5. Remedies
6. Conclusions

# COMPETITION COMMISSION



## Introduction 1 - Value chain for equities exchanges





## Introduction 2 – The parties

### 1. LSE

- Equities trading: electronic and non-electronic order books
- Derivatives trading: 76% ownership of EDX London

### 2. Euronext

- Equities trading: Paris, Amsterdam, Brussels, Lisbon exchanges
- Derivatives trading: LIFFE exchange

### 3. Deutsche Börse

- Equities trading: Frankfurt Stock Exchange
- Derivatives trading: Co-ownership of Eurex (with SWX)



## Introduction 3 – Markets affected by the proposed mergers

- Listing services
- Equities trading services
- Derivatives trading services
- Post-trade services
  - Clearing services
  - Settlement services
  - Custody and banking services
- Information services
- IT services

- ⇒ We will focus on:
- ✓ Equities trading services
  - ✓ Their interaction with post-trade services



## Competition in trading 1 – what competition?

- Network externalities imply “winner-take-all” competition:

### Doesn't feature:

- ⇒ Switching by individual trading firms;
- ⇒ Fragmentation of liquidity (in Europe);
- ⇒ Frequent competitive events;

### Can feature:

- ⇒ Possibility of switching for groups of (big) firms;
- ⇒ Some form of “limit pricing”
- ⇒ Occasional (off-equilibrium) attempts to shift liquidity in head-to-head competition;



## Competition in trading 2 – what competitive pressures?

- Exchanges compete as they represent a “credible” threat to each other’s business;
  - ⇒ One type of “potential competition”;
  - ⇒ Switching costs do not necessarily limit competition;
  - ⇒ Competitive pressures in negotiations between the exchange and trading firms (threat to “sponsor” entry).



## Competition in trading 3 – market definition

- Market definition

⇒ Market features make it difficult to use a straightforward SSNIP test;

### Geographic dimension:

⇒ The relevant market should include all entrants posing a credible threat;

### Product dimension:

⇒ Little constraint placed by off-book trading;





## Competition in trading 4 – What makes a credible competitor?

- Main conditions for a competitor to shift liquidity
  - ⇒ Offer a better and low-price service;
  - ⇒ Ability to supply such service at low cost;
  - ⇒ Customers able to move in a coordinated fashion;
  - ⇒ Customers' dissatisfaction;
  - ⇒ No regulatory or political barriers;
  - ⇒ **Full access to the existing clearing and settlement infrastructure**

# COMPETITION COMMISSION

## Competition in Trading 5 – Previous attempts at head-to-head competition



1995/ 2000	Tradepoint/ virt-x	Tradepoint offered electronic order book trading services in advance of LSE. Relunched under new ownership in 2000 as virt-x. Virt-x provides UK base for trading Swiss equities as well as pan-European trading of blue chips.
1996/ 2001	Easdaq/ Nasdaq Europe	Easdaq was aimed at European high growth companies. Relunched in 2001 as Nasdaq Europe. Ceased operating in 2003.
2000	Jiway	Joint venture by OMX and Morgan Stanley to provide pan-European trading in Europe and US stocks. Ceased operating in 2002.
2003	Nasdaq Deutschland	Joint venture with two regional equity exchanges in Germany. Ceased operating in August 2003.
2004	DTS	LSE's entry into trading Dutch equities. Encouraged by market participants dissatisfied with Euronext Amsterdam. Has achieved minimal trading volumes.
2004	Project Tiger	Euronext's planned entry into trading UK equities in response to DTS. Plan later dropped by Euronext.

# COMPETITION COMMISSION



## Competition in trading 6 – Competitors to LSE

- Closest competitors: European and US exchanges
  - UK regulated exchanges: virt-x
  - major European equity exchanges: DBAG, Euronext
  - mid-size European equity exchanges: OMX, Borsa Italiana, BME (Spain), SWX
  - US exchanges: NYSE, NASDAQ
- “Slack constraints”: Other trading systems—‘off-book’ trading
  - internalisation
  - bilateral (over the counter) trading
  - Alternative Trading Systems

# COMPETITION COMMISSION



## The Substantial Lessening of Competition (SLC)

- Horizontal impact of the mergers

- ⇒ The elimination of either EN or DBAG as credible entrants in itself does not lead to an SLC as there are enough other credible entrants.

- Foreclosure

- ⇒ Both EN or DBAG would have the ability to influence their CCP so to deny “full fungibility” to perspective entrants. So both mergers would lead to an SLC.

# COMPETITION COMMISSION



## SLC 2 - How would foreclosure work?

### Incentive:

- both Euronext and DBAG would have the incentive to influence LSE's clearing services provider to impede the establishment of a trading service that competed for trades currently conducted on LSE

### Ability:

- Euronext: would be able to influence LCH.Clearnet due to its shareholding, board representation and importance as a customer
- DBAG: would be expected to replace LCH.Clearnet with its own clearing provider (Eurex Clearing), which it controls



## Remedies 1 - Identification of effective remedies

- Effective remedies need to provide certainty and confidence of non-discriminatory access to clearing.

### Foreclosure mechanisms:

- Refusal to supply
- Discrimination in terms of access provision
- Frustrating a potential competitor (lack of co-operation on timeliness, confidentiality, IT interconnection etc)
- Cross-subsidization



## Remedies 2 - Customer benefits, costs and restrictions

- (Fixed) cost and other savings in trading services
  - Cost and restrictiveness of effective remedy options
    - E.g. : Prohibition of using Eurex Clearing would reduce rivalry in clearing services
- The chosen package of remedies has both structural and behavioural elements.

# COMPETITION COMMISSION



## Conclusions

### On competition between exchanges

- Exchanges do compete (via the threat of “entry”);
- Off-book alternatives are constraints of a second order;
- Access to incumbent’s post-trading services is key to competition in trading services

### On competition policy

- Use of evidence in potential competition (eg internal docs);
- Importance for the conclusions on market definition and SLC to be seen in the context of the inquiry (cpr. Bundeskartellamt finding)