



LSE, NYSE, OMX, Nasdaq, Euronext ... Why Stock Exchanges Are Scrambling to Consolidate

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To anyone who thinks of a stock exchange in terms of a bustling trading floor, the Nasdaq Stock Market's offer earlier this month to buy the London Stock Exchange might have been surprising. If the whole point of an exchange is to bring buyers and sellers together in one place, how could Nasdaq manage if separated from its other half by an ocean?



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Easy -- through wires, fiber-optic cable, satellite links and massive computers. In fact, traditional trading floors are fading away, and the 35-year-old Nasdaq has never had one; it's always been all-electronic. The Nasdaq-LSE offer -- initially declined but likely to be sweetened or beaten by another suitor -- is just the latest step in a long industry-wide evolution that includes consolidation, automation and conversion of privately held exchanges into public ones.

"There's an obvious advantage in centralizing exchanges," says Wharton finance professor [Richard J. Herring](#). Bigger exchanges enjoy economies of scale that reduce trading costs. That attracts more traders and listing companies. And as trading volume increases, it's easier for buyers and sellers to find one another. The improved liquidity helps share prices respond more quickly and accurately to changes in supply and demand.

The Nasdaq-LSE offer follows an unsuccessful bid for the London exchange by OMX, the Swedish Stock Exchange, in 2000. (OMX later bought exchanges in Denmark, Finland, Estonia and Latvia.) In recent years, LSE also rejected bids by Euronext which runs exchanges in Paris, Amsterdam, Brussels and Lisbon, by Deutsche Boerse, which runs the Frankfurt exchange, and by Macquarie Bank of Australia. Now the Nasdaq move has triggered speculation about a variety of possible combinations: The New York Stock Exchange merges with Deutsche Boerse, the NYSE ends up with Euronext or LSE, Euronext buys Deutsche Boerse or LSE....

"Part of the reason this is happening is that there is a drive to have a single market in financial services," says [Franklin Allen](#), professor of finance and economics at Wharton. "That's a big thing in Europe. At the moment, they have far too many exchanges. Clearing and settlement [bookkeeping to complete transactions] aren't nearly as smooth as they should be, and transaction costs are too high." Allen estimates there is a 60% to 70% chance the LSE will merge with Nasdaq. But other Wharton experts interviewed note that while further consolidation among exchanges is likely, it is too early to predict the final pairings.

Moving Away from Human Intervention

Exchange consolidation, according to Herring, began hundreds of years ago, when small exchanges serving individual European cities were gradually merged to create bigger, centralized exchanges in cities such as Antwerp, Amsterdam and London. Another wave of consolidation began in the 19th century with the invention of the telegraph. "Exchanges were really separated by barriers of time and space before then."

In recent years, the advent of advanced computers and other forms of communication have allowed markets to operate worldwide, even as the marketplace itself has changed. Only a few decades ago, most stocks were owned by individuals. Today, the majority of shares are held by institutions such as mutual funds, hedge funds, pension funds and insurance companies.

Institutions making enormous trades need the vast liquidity that can be offered by large exchanges, says [Ma](#) [Marshall E. Blume](#), finance professor at Wharton. "Institutional shareholders are becoming increasingly sophisticated and cost conscious." Institutions also worry about shady practices sometimes found at traditional auction-type exchanges dominated by individuals on a trading floor, Blume adds. For example, a floor specialist who knows what his big institutional customer is willing to pay for a block of stock can sometimes buy the stock himself at a lower price, then sell it to the customer at the higher one. This illegal "front-running" deprives the institutional buyer of the lower price the specialist should have provided by simply bringing buyer and seller together.

To avoid such maneuvers and squeeze out costs, institutional investors have pressed for ever greater computerization and a move away from the human intervention found on traditional trading floors, Blume notes.

Responding to this pressure, the New York Stock Exchange in early March completed a merger with Chicago's Archipelago Holdings, a nine-year-old, all-electronic trading system. The merger also will allow the NYSE to enter markets for options, futures and smaller stocks. To pay for the \$10 billion deal, the exchange at the same time converted to a publicly held company.

Many exchanges have gone public in recent years to raise money needed for acquisitions and to break free of a traditional member-ownership system that stifled change, Blume says, adding that "the exchanges used to be likened to country clubs." They were owned by the seat-owners who earned fees for conducting customers' trades.

The NYSE was long a non-profit entity, and its members had a vested interest in preserving the floor-trading system that was going out of fashion. Although it is the largest exchange in the world, measured by total market capitalization of the companies listed on it, the NYSE has been gradually losing market share, according to Blume.

NYSE leaders convinced members to go public by offering shares in exchange for their memberships. The members-turned-shareholders now have a vested interest in supporting change -- like the Archipelago acquisition -- that will help the exchange compete with all-electronic operations, driving up NYSE share price.

"It would be very hard to do that under the old NYSE system because it would hurt the traders' economic interests," Blume notes. "But now it doesn't hurt the traders' interests because the traders have stock."

Like Nasdaq, the London Stock Exchange is all-electronic and publicly traded, making the two companies a good fit, according to Nasdaq executives. The LSE initially rebuffed the Nasdaq's informal \$4.1 billion offer. But the bid drove LSE share prices up by 30% as investors bet the Nasdaq -- or perhaps the NYSE or other suitors -- would up the ante.

Avoiding Sarbanes-Oxley

In recent years, U.S. exchanges have had a difficult time competing with foreign exchanges for new corporate listings, partly because regulation is less stringent outside the U.S. This may be another reason Nasdaq and the NYSE are interested in teaming up with foreign exchanges.

The Sarbanes-Oxley law enacted in the wake of the Enron scandal, for example, requires expensive new auditing procedures and makes chief executives and chief financial officers legally liable for the accuracy of their firms' financial statements. "The Sarbanes-Oxley requirement has made it pretty unattractive for companies who haven't already listed here to choose the U.S.," Herring says.

In addition, Blume notes, many institutional traders are unhappy with the so-called "trade-through" rule in the U.S. "It causes an integration of all the markets and that's a very expensive thing to do, and institutions don't like it." The rule involves a National Market System (NMS) that links exchanges around the country so that traders get the best prices available anywhere. A buyer placing an order through the NYSE might, for example, be matched with a seller on the Nasdaq or Philadelphia exchange if that seller offered a lower price than anyone on the NYSE.

While that sounds good, it means large institutional trades often are broken into numerous smaller ones, increasing costs and making transactions take longer. Many institutional traders prefer to trade in large blocks very fast, even if prices are not quite the best.

By acquiring a foreign exchange such as the LSE, the Nasdaq could serve listing companies that want to avoid Sarbanes-Oxley requirements, and it would serve traders who want to skirt the NMS rules.

Although all these arguments make sense to merger proponents, there's no guarantee any U.S.-European merger would pay off, according to [Eric K. Clemons](#), management and operations professor at Wharton who once served as a consultant to the London Exchange. "I can't think of a compelling economic reason for it."

Because there would continue to be two largely separate entities, one in the U.S. and one overseas, there may not be much opportunity to cut costs, typically a chief goal of consolidation, he notes. And although some companies and traders don't like regulation, the U.S. securities markets have long been the most successful in the world despite being the most heavily regulated; indeed, some see that regulation as a benefit, providing a level of safety and disclosure not available elsewhere.

Moreover, Clemons says, consolidation across the Atlantic may not provide significant benefits beyond those that could be more easily accomplished with some form of partnership -- the way two airlines work together to build routes that neither offers by itself.

Finally, creating a big international exchange may be serving a need that doesn't exist. Traders, he says, already have the opportunity to buy and sell on foreign exchanges simply by dealing with brokerages, such as Merrill Lynch, that operate on exchanges worldwide. "You can trade on any exchange, regardless of what country you are in."

But although the economics of cross-ocean mergers might be questionable, stock exchanges around the world appear to be convinced that bigger is better -- and that those who don't join the party will end up wallflowers at the dance. Nasdaq's bid for the London exchange may be motivated, in part, by this fear, as well as a dose of empire-building fever, Clemons suggests. "There are a lot of reasons why management teams like to control bigger stuff."

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