

KEY POINTS

- Technological developments make it easier to acquire financial products online and affect the way stock exchanges compete.
- There has been an increase in competition among stock exchanges to secure a market share in geographic markets (economies of scale) and on different activities (provision of services).
- The regulatory regime that may follow a stock exchange merger may affect the desirability of listing/trading on the merged entity.
- Sound and effective regulation is the key to the development and integration of stock exchanges in the global market.

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Regulation of stock exchanges in the recent wake of mergers

EUROPEAN DEVELOPMENTS IN CROSS-BORDER STOCK EXCHANGE MERGERS

European stock exchanges are turning into public listed organisations, after demutualisation, and aim at maximising profits for their stockholders. Stock exchanges are moving from an era of monopolies to a new era marked by competition. A study shows that 60 new financial stock exchanges were created between 1990 and 1999.¹ The likely contributing factors include:

- economic freedom in taxes;
- a sound regulatory structure enhancing the de-regulatory trend;
- an increasing number of main players, ie investment banks channelling investors' towards stock exchanges; and
- the existence of larger economies.

In contrast, technology shocks that increase communication links reduce the likelihood of new exchanges being physically established. The new wave of economic communications networks, or 'ECN's – in the absence of regulatory barriers – render industry entry much easier than ever – since technological advances decrease the costs of establishing a stock exchange.²

Several institutional changes were common in stock exchanges in Europe in the last two decades, namely: (1) mergers and acquisitions; (2) changes in the ownership structure in a number of quoted companies; and (3) extension of trading hours. Stock exchanges have merged with derivative exchanges (eg Euronext and LIFFE) and with settlement operators (eg Deutsche Börse and Clearstream). Mergers that have focused on combining different geographic markets aim at exploiting the economies of scale in

Stock exchanges across the globe have been the subject of merger discussions following market pressure to cut costs and become more competitive. Mergers that focus on combining different geographic markets aim at exploiting the economies of scale in trading. Mergers that have combined different activities aim at providing a more complete financial service to customers. The aim of this article is to provide an overview of general regulatory issues affecting stock exchanges mergers adopting a substantive rather than jurisdictional approach.

trading. Those which have combined different activities aim at providing a more complete financial service to customers.

Stock exchanges across the globe have been the subject of merger discussions following pressure to cut costs and become more competitive. Besides the NYSE's acquisition of Euronext, which operates exchanges in Paris, Amsterdam, Brussels and Lisbon, Nasdaq recently agreed to buy Nordic stock exchange operator OMX AB. The LSE has been the subject of constant speculation since Deutsche Boerse AG launched a £1.35bn takeover bid in December 2004. Further approaches or interest from Euronext NV, the NYSE Group Inc, Australia's Macquarie Bank Ltd, and Nasdaq have sent the value of the LSE rocketing. Its shares have more than trebled from 414p before the Deutsche Boerse approach. The LSE agreed in principle, on 22 June 2007, to acquire Borsa Italiana in an all-paper transaction valued at about €1.6bn (£1.1bn).

Cross-border mergers trigger a series of different issues. From a transactional point of view, these issues include the synergies that a merger creates, the complexities in achieving an optimal financial structure, the protection of minority shareholders etc. From a regulatory standpoint, issues can be internal (compliance with rules of the stock exchange) or external (compliance with the regulatory requirements of the competent

regulatory body or bodies). Regulatory issues can affect the parties involved in the stock exchange or the stock exchange itself. Moreover, these issues can be exteriorised at a national or international level. For example, the London Stock Exchange ('LSE') is subject to the UK Financial Services Authority and EU directives (namely MiFID, the Market Abuse Directive, the Prospectus Directive, the Transparency Directive and the Capital Adequacy Directive). In the same way, it can be argued that the New York Exchange ('NYSE') abides by its own rules, the regulations imposed by the US Securities and Exchange Commission ('SEC') and state and federal rules. Moreover, both the LSE and NYSE are subject to international soft-law (eg International Organisation of Securities Commissions – 'IOSCO') and external treaty obligations (eg General Agreement on Trade in Services – 'GATS'). In addition, stock exchanges may be faced with the extraterritorial application of laws to their members as result of a dual listings or a private placement sell.

A BRIEF ANALYSIS OF STOCK EXCHANGES

A capital market is a market within a financial system that provides a range of investment and financing tools. Capital markets can be considered as primary capital markets (for an initial issuance of securities) or secondary

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capital markets (for the trading of securities previously issued). Moreover, capital markets operate with securities which can either be equity securities (ie shares of a company, be it by means of an initial issuance or initial public offering ('IPO') or by subsequent purchases and sales in the secondary market) or debt securities (eg bonds or other listed debt instruments). A transaction in a capital market can take place on the market itself ie on a formal stock exchange; or off-the market ie off the stock exchange. If it occurs off the market it is considered an over-the-counter ('OTC') transaction.

A stock exchange is a formal (regulated) capital market where securities (equity and debt) are issued (primary market) and traded (secondary market).

In the economic academic literature,³ there are at least three views of stock exchanges: the exchange as a market or trading system; the exchange as a firm and the exchange as a broker-dealer.

A stock exchange is a market or trading system that must: (1) provide trade execution facilities; (2) provide price information in the form of buy and sell quotations on a regular or continuous basis; (3) engage in price discovery through its trading procedures, rules, or mechanisms; (4) have either a formal market-maker structure or a consolidated limit order book or be a single price auction; (5) centralise trading for the purpose of trade execution; and (6) exhibit the likelihood, through system rules and/or design, of creating liquidity in the sense that there is an entry of buy and sell quotations on a regular basis – such that both buyers and sellers have a reasonable expectation that they can regularly execute their orders at those quotes.⁴

In addition, a stock exchange can then be seen as a firm that produces a composite good – the exchanging of securities – which may be made up of different elements such as price formation, counterpart research, insurance for a good clearing, and the standardisation of the good exchanged.⁵ According to this view, the owners of the exchange should satisfy all the interested entities: intermediaries, issuers, and investors. Due to ownership structures, some of the customers may be the owners of the stock exchange as well. Thus, the price for

some of the products of the stock exchange eg trading fees can influence the shareholders' value. Private management and ownership may give greater efficiency to the exchange.

Finally, according to the view of the exchange as a broker-dealer, the stock exchange is a kind of intermediary among intermediaries. The stock exchange gathers trading orders and supplies the way of executing them.

An exchange facilitates information production, its dissemination and competition amongst traders. To facilitate this interaction a stock exchange provides a market place where new shares are issued in companies seeking a listing and where those shares can be traded between investors. A stock exchange is responsible for setting criteria which a company must meet to obtain a listing and must comply with to retain that listing. An exchange also has to ensure that the market place for securities which it operates works efficiently and is as transparent as possible. Finally a stock exchange regulates direct access to the market place through membership admission and subsequent rules.

The revenues of the exchange are mainly derived from the following sources: (1) trading fees (membership and trading fees); (2) listing fees (initial and yearly listing fees); (3) information and price-dissemination fees; (4) settlement fees; and (5) development and sale of proprietary software.

Customers of stock exchanges can be divided into direct and indirect customers. Direct customers of exchanges' services list on an exchange. In addition, direct customers are intermediaries who are admitted to trading as well as information vendors. Indirect customers send orders to intermediaries to be executed on an exchange: institutional investors and all other financial intermediaries (if not allowed to trade directly) and single customers (both, physical or legal entities).⁶

TRENDS IN LEGISLATION REGARDING THE REGULATION OF STOCK EXCHANGES

Globalisation, internationalisation, integration, deregulation, as well as technological advances have led to legislative changes such as the Investment Services

Directive ('ISD') and its successor, the Markets in Financial Instruments Directive ('MiFID'). These Directives, aimed at the harmonisation of regulation, have led to the creation of a new regulatory environment for capital markets in Europe. This trend has increased the number of international investors in the European capital markets and has provided impetus to mergers of stock exchanges as a means to facilitate cross-border listings and trading.

The ISD, effective since January 1996, was the legislative centrepiece of the single market programme for securities. According to the ISD, each recognised exchange is automatically accepted in other European Union ('EU') countries and offers remote access to intermediaries in other EU countries without imposing further regulatory burdens. In addition, the ISD promoted remote membership and price disclosure. Member states that implemented the ISD could guarantee their investment firms freedom of establishment and freedom to provide services in other EU states.

The EU's Financial Services Action Plan ('FSAP') – a comprehensive 42-measure plan to harmonise member states rules with the aim of streamlining the integration of the EU markets – highlighted the need to update the ISD. Moreover, in 2000, the European Council set up the Committee of Wise Men on the Regulation of European Securities Markets to analyse and come up with recommendations on the law-making process concerning securities markets regulation in the EU aiming to make the process more expedite and flexible in order to incorporate market developments. In 2001 the final report by the Committee – commonly known as the Lamfalussy report honouring the chairmanship of the Committee – was published and some of its recommendations were adopted by the European Council.

The ISD has been superseded by MiFID which will introduce a single market and regulatory regime for investment services in the EU. The objectives of MiFID are to complete the EU single market for investment services and to respond to changes in the securities markets by means of basic high-level provisions governing the organisational and

conduct of business requirements that should apply to financial services firms.

SPECIFIC ISSUES ON THE REGULATION OF STOCK EXCHANGES

As seen from previous paragraphs, another important aspect of stock exchanges is regulation. Regulation, as noted by Lastra, refers to the establishment of rules, to the process of rulemaking and includes legislative acts and statutory instruments issued by the competent authorities nationally and supra-nationally, international rules, and rules issued by self-regulatory organisations and private bodies or 'clubs'.⁷ Abrams and Taylor argue that to constitute an effective regulatory structure, the regulatory agency or agencies that have to perform supervisory functions must: (1) have clear objectives; (2) be independent and accountable; (3) have the necessary resources to perform the tasks commended; (4) have effective enforcement powers; (5) have comprehensive rules covering all aspects; (6) be cost efficient; and (7) have a structure that reflects the structure of the industry that it or they have to regulate.⁸

In addition, specific regulation by itself would not be sufficient unless there are: (1) sound corporate governance practices; (2) preventive measures to avoid unfair barriers to entry, anti-competitive practices and abuse of a market dominant position; (3) tax laws; (4) dispute resolution mechanisms; (5) an insolvency framework; and (6) a respect for the rule of law.

The interaction between regulation and enforcement is carried out by supervision which in a broad sense includes the following areas:⁹ (1) licensing; (2) supervision *stricto sensu*; (3) sanctioning for non-compliance or breaching the applicable set of norms; and (4) crisis management. Crisis management in financial institutions can become something of utmost importance due to the special characteristics of certain financial institutions and the risk that they entail (systemic risk) to the financial system. However, according to Allen and Herring, systemic risk refers mostly to banks rather than securities markets since securities firms are less vulnerable to runs and a contagious transmission of shocks

and therefore are less likely to be a source of systemic risk.¹⁰

As noted by Abrahams and Taylor, changing the structure of regulation cannot itself guarantee effective supervision.¹¹ Although there is no single correct approach to a regulatory issue, regulation should promote transparency of trading to deter manipulation and ensure the proper management of large exposures, default and market disruption.¹²

Kahan contends that stock exchanges are subject to significant incentive and enforcement problems when it comes to designing and administering securities regulations.¹³ Another matter that should be stressed is the clashing interest of stock exchanges in efficient regulation vis à vis their interest in maintaining a competitive market share. A balance between these two issues is difficult to achieve since excessive regulation or compliance requirements in some cases has been a disincentive for issuers. Competition among different stock exchanges with different regulatory systems will force regulators to be responsive to investors' needs.

The aim of regulation of stock exchanges and its enforcement is to provide confidence to investors. If investors are confident with the market, they will be attracted to invest and therefore the capital markets will grow. In order to understand the dynamics of market regulation, we must consider the difficult problem faced by an exchange that wishes to attract investors with low transaction costs, efficient prices, and transparency while simultaneously earning a competitive return.¹⁴ Benston argues that competition among stock exchanges and privately developed technology, such as automated trading or trading on the internet, has contributed to enhance the benefit to investors.¹⁵

As a result of globalisation and deregulation we have been faced with an increased number of changes in the international financial markets. These changes have been exacerbated by the current business cycle and the need for big amounts of money to finance ongoing transactions. In addition, the technical evolution of communications has provided better and more reliable resources for the financial industry. All these factors

together with deregulation and harmonisation achieved by means of soft law have led to an expansion of financial services. It is worth stressing that most of these changes – that started in the late 1970s and early 1980s, led to a truly international financial market in the early 1990s, which has moved extremely fast as result of the use of the Internet.

One of the lessons the IMF has drawn from the Asian crisis is the need for proper sequencing of capital account liberalisation and financial sector development – including supervision and regulation, risk management and transparency.¹⁶ The Asian financial crisis triggered several proposals to reform the international financial system. These proposals, focusing on the prevention and avoidance of financial crises, have dominated the new International Finance Architecture. In the wake of the new International Finance Architecture international organisations such as the IOSCO and the International Accounting Standard Committee ('IASC') are very active in the study, co-ordination and promulgation of international standards in the area of financial market regulation and disclosure. Although their promulgations have the characteristic of being 'soft law', they are being adopted and transformed in law in developing and developed countries at both domestic and regional level. The most relevant documents on stock exchanges in the international arena are IOSCO's 2002 Objectives and Principles of Securities Regulation and the World Federation of Exchanges 2002 Market Principles. Also, in the area of payment and settlement, the Committee on Payment and Settlement Systems ('CPSS') – under the auspices of the Bank for International Settlements ('BIS') – has played an important role through the publication of the Core Principles for Systemically Important Payment Systems, the CPSS/IOSCO Recommendations for Securities Settlement Systems and the CPSS/IOSCO Recommendations for Central Counterparties. In addition to the international standards, specific market associations have played a key role by providing standardised contractual terms, eg the 'Global Master Repurchase Agreement' or the 'Convertible Asset Swap

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Transaction' provided by the International Capital Market Association ('ICMA') and the International Swaps and Derivatives Association ('ISDA') respectively. The latter has played a very important role in the harmonisation of contractual terms since the drafters were market participants themselves – which has implicitly guaranteed their widespread adoption.

These initiatives and the referred documentation has helped the role of EU regulators since integration of countries – that followed these principles laid down by international organisations and associations, eased the harmonisation of different legal systems. The FSAP and the Lamfalussy report with its four-level procedure (framework principles; decision making; national implementation and co-operation; and enforcement) also played a key role in the streamlining of financial regulation within the EU. These resulted as previously mentioned

free trade association, a positive movement towards the unification of the international financial markets has been accomplished among two of its three members (US and Canada). The multi-jurisdictional disclosure system ('MJDS') was designed to facilitate securities offerings in multiple markets by subjecting the issuer to the regulations of only one country. Due to the similarities between the US and Canadian securities laws, the Securities Exchange Commission ('SEC') authorised Canadian issuers that had complied with their local regulations to issue securities in the NYSE and/or National Association of Securities Dealers Automated Quotation System ('NASDAQ'). Unfortunately, the MJDS, since its adoption in 1991, has not been extended to other countries and regrettably since 1993 it is still necessary to reconcile financial statements with US general accepted accounting principles ('GAAP').

services in markets where they are willing to gain access. This need to establish links with competitors is the building stone towards a 24-hour stock exchange operating through different time zones around the globe, from Asia to North America through Europe.

However, despite all these changes and the needs of the parties involved, one should not lose sight of the three – interrelated and sometimes overlapping – core objectives of securities regulation laid down by IOSCO: (1) the protection of investors; (2) ensuring that markets are fair, efficient and transparent; and (3) the reduction of systemic risk.²⁰ It should also be borne in mind that stock exchanges, as financial institutions operating in financial markets, are prone to risks and exposure. These risks include (1) credit risk; (2) market risk; (3) interest rate risk; (4) foreign exchange risk; (5) operational risk (which includes settlement risk); and (6) legal risk.

Modern financial regulation is based on risk management²¹ posing a challenge to financial firms to develop market-risk management techniques and to investors and regulators to observe and quantify risk. Particularly in the UK – as noted by Alexander – the Financial Services and Markets Act 2000 ('FSMA') and its accompanying regulations create a regime founded on a risk-based approach to the regulation of all financial business.²² From a UK perspective, it can be argued that the risk-based approach can be divided into two: (1) a general risk approach; and (2) a specific risk-by-risk approach as identified under the Financial Services Authority's ('FSA's') prudential sourcebook. Although regulation should take into account the risks associated with stock exchanges, it should by no means deter the reasonable risks of the industry. On the contrary, regulators should allow the effective management of risks by establishing safety nets to monitor risk taking and eventually by adopting the necessary measures (eg minimum capital requirements) to create a buffer against unforeseen circumstances affecting financial markets.

Carmichael and Pomerleano argue that in principle there are two fundamentally different models of regulatory structure (ie based either on institutions or on functions).²³ However, lines have blurred and most

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in the adoption of the ISD as superseded by MiFID. Other directives are also relevant in the area of securities regulation, ie the Market Abuse Directive; the Prospectus Directive, the Transparency Directive and the Capital Adequacy Directive. In addition, a communication on clearing and settlement was issued in April 2004¹⁷ to improve clearing and settlement allowing market participants to operate effectively in an integrated EU financial market. In this regard, the European Commission has noted that the situation as of today is complex and fragmented, imposing costs, risks and inefficiencies on investors, institutions and issuers.¹⁸ Moreover, a draft proposal for a Directive of the European Parliament and of the Council on payment services in the internal market has been produced and the final implementation of the Directive is expected for 2008.

While the aim of the EU and the North American Free Trade Agreement ('NAFTA') differs since the latter only looks to create a

On the one hand, with all these changes, financial markets have gained in soundness. IOSCO recognises that sound domestic markets are necessary for the strength of a developed domestic economy and that domestic securities' markets are increasingly being integrated into a global market.¹⁹ Therefore, a significant amount of credit has shifted from banks to the capital markets in the form of securities. In today's current state securities are more liquid, easily transferable and have lower transaction costs. On the other hand, the fact that stock exchanges have become public listed companies, as any other company, means that they need to produce dividends, ie gains for their shareholders. Moreover, as result of globalisation and in order to be able to compete with digital platforms and keep on generating revenues they are faced with the need to have an international presence in key financial districts. This has led to their need to acquire other players or merge and/or establish links with their competitors or providers of similar

regulatory structures in the world contain elements of both.

The regulatory structure based on 'institutions' fosters the establishment of different separate legal entities to regulate different aspects (eg prevention, functioning, crisis management, etc) of different financial service sectors (ie banks, insurance and securities). In some countries, two of the sectors are regulated together (eg securities and insurance, banking and securities or banking and insurance – but at least there are two different regulatory bodies).²⁴ The weaknesses of this type of regulatory structure are, *inter alia*: (1) inefficient use of resources; (2) fragmented supervision; and most importantly (3) regulatory arbitrage by large financial conglomerates.

The regulatory structure based on 'functions' argues for the establishment of separate agencies to regulate different sources of market failure (inefficient allocation of goods and services by the market) for the benefit of consumers' needs by establishing an equilibrium in the economy. The rationale behind this theory is that different 'function' regulators will tackle the causes of the disequilibrium (competition, market conduct, asymmetric information and systemic stability). Obviously, this theory has strengths (eg alignment of the regulation with the underlying source of the market problem) and weaknesses (overlap, conflict of agencies and the resulting compliance inefficiency).

A third possible alternative in financial regulation-supervision is a unified regulatory body as in the UK, Norway and Denmark (and more recently Germany and France). However, although it is said that a single regulator offers the best solution to efficiency, accountability, conflict problems and effective regulation of conglomerates (reduction of regulatory arbitrage), the Centre for Policy Studies produced a report in 2005 stating that the FSA (UK's single regulatory body) was 'one of the most powerful, and one of the least accountable, institutions created in the UK since the war'.²⁵

Another issue to be considered is how many supervisory bodies should be required for the surveillance of stock exchanges. In this matter, Lastra²⁶ argues that there is no single answer

due to the lack of empirical evidence and that it can be a single body as in the UK, Norway, Denmark, Germany and France, different bodies for different industries (ie banking, securities, insurance, etc) as in Italy or Spain or multiple authorities within the industry as in the US. The case of the US is very interesting since there are four sets of norms issued by different regulators: (1) federal laws passed by the US Congress; (2) state laws passed by State legislatures; (3) regulation enacted by agencies (eg SEC); and (4) regulation enacted by self-regulatory organisations or self-regulatory organisations ('SRO's) (eg NASDAQ, NYSE, the Chicago Board Options Exchange, the Chicago Mercantile Exchange).

In addition, supervision can be performed by public, private or both types of bodies. However, considering the sensitivity of matters involved in the event of a wrongdoing and the potential consequences for the

communicate an invitation or inducement to engage in investment activity unless they are authorised by the FSA. Under s 138 of the FSMA, the FSA has the capacity to enact rules – although specific reference is made to Economic European Area firms and the capacity of those firms' home state regulator. Those persons authorised by the FSA will have to comply on an ongoing basis with the FSMA and the FSA's *Handbook of Rules and Guidance*.

Sound and effective regulation is key to the development and integration of stock exchanges in the global market. Soundness can be achieved by effective regulation and effective regulation relies on the need for supervision. Effective regulation will provide confidence and attract investors. Confidence and more investors will allow the stock exchanges to grow and interact. The interaction might lead to mergers but at the least will facilitate information sharing,

"Effective regulation is key to the development and integration of stock exchanges in the global market."

economy as a whole (eg the Asian crisis) or the role to be performed by the government in the event of a crisis (eg the Drexel Burnham Lambert Group, Baring Bros or Long-Term Capital Management Fund collapse cases), a certain degree of public involvement is required. If a failure does occur, regulation should aim at reducing its impact by isolating the distressed entity and avoiding disruption to the markets. In other words, avoid contagion, ie systemic risk.

Supervision requires initial scrutiny to grant a licence and ongoing supervision to maintain the permission granted to operate. Ongoing supervision implies compliance with the required filings, meetings with officials from the supervisory body, inspections and additional disclosure that may derive from such inspections and fulfilment of any resolution or sanction that might be imposed by the regulatory body. In the UK, ss 19 and 21 of the FSMA impose a general prohibition on persons, in the course of business, to carry out regulated activities and/or

harmonisation, integration facilitating disclosure (pre-trade and post-trade) – one of the pillars in regulation since it promotes transparency – and by means of transparency, investors' protection is fostered.

CONCLUDING REMARKS

As this analysis indicates, the merging of stock exchanges is now a strong trend in the financial industry. It would be useful to present the benefits of financial integration: London Economics prepared a report for the European Commission on the integration of EU financial markets. In this report it argued that:

'through a more open and effective European financial market a number of benefits are expected for both investors and the corporate sector. Investors will benefit from higher risk-adjusted returns on savings, through enhanced opportunities for portfolio diversification and more liquid and competitive capital

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Bio box

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markets. The corporate sector will benefit from generally easier access to financing capital. Competition in the financial intermediation sector will offer corporations a wider range of financial products at attractive prices.²⁷

If the LSE-Borsa Italiana merger goes ahead,²⁸ this would be the latest in a series of consolidations in the industry. The LSE has been a reluctant partner in the past since it rejected approaches or interest from the Nasdaq, the New York Stock Exchange, Deutsche Boerse, Euronext and Australia's Macquarie Bank.

It should be emphasised that although sound and effective regulation is key to the development and integration of stock exchanges in the global market, there is no single regulatory structure suitable to all countries.²⁹ Each country has to develop the regulatory structure that best suits its needs according to its idiosyncrasy, taking into account historical, cultural, political, social and economical issues, as well as new elements resulting from the cross-border stock exchange mergers.

Finally, it should also be stressed that the nature of regulation rests on an ever-changing environment. For this reason, Seligman considers that stock market regulation is a work in progress.³⁰ The burden falls on competition and regulatory authorities to ensure that effective and sufficient competition remains after any consolidation in the stock exchange industry. ■

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