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DEBATE PACK

Number CDP-054, 15 February 2017

The Future of the London Stock Exchange

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Summary

Sir William Cash will introduce a Westminster Hall debate about the future of the London Stock Exchange Group (LSEG). This is in the context of uncertainty around the City of London post - Brexit and, more immediately, the ongoing proposed merger between the LSEG and Deutsche Borse. The merger has been approved by the shareholders of both organisations and, currently, the main obstacle to this merger appears to be EU competition authority approval. There is a full chronology of the merger process with accompanying official documents and other material on the LSEG website here.

Contents

1. Background

Summary

The London Stock Exchange has, in various guises existed for 300 years. It is a public company like any other, with shareholders and profitability as its guide.

As a public company it has looked for commercial expansion both through the range of its products (the main index and subsidiary markets like AIM) and expansion abroad often via mergers. In July 1998 LSE chief executive Gavin Casey revealed plans to form a "strategic alliance" with none other than Deutsche Borse.

The current London Stock Exchange Group was created in October 2007 when it merged with Milan Stock Exchange, Borsa Italiana. Worldwide, Between 1999 and 2012, 18 stock exchanges were reduced to just five therough a series of mergers.

The latest merger proposal between LSEG and Deutsche Borse was approved by the shareholders of both companies in August 2016. It would take place against the backdrop of an uncertain period for the City of London post referendum and some confusion over the intended whereabouts of the new group's headquarters.

1.1 Introduction

When he introduced proceedings on the first day of the *Company Law Reform [HL] Bill* ,the Minister, Lord Sainsbury, said:

> One hundred and fifty years ago my predecessor Robert Lowe, later Viscount Sherbrooke brought forward the bill that created the joint stock limited liability company. It was the first nationwide codification of company law in the world, and he has been described as the 'father of modern company law'.[1]

The creation of joint stock status was one of the great inventions of, and contributions to, modern commercial life made by this country. It existed long before the company law that was to regulate it. Elizabeth Hennessy, writing in *Coffee House to Cyber Market*, states that at the end of the 17th Century there were 140 joint stock companies with a capital value of £4.5 million, most of which could be traded at Johnathan's coffee house, from which the current stock exchange traces its roots.

But, the separation of ownership from management of a company requires the services of an exchange to both bring in money and to provide a fora for shares to be transferred.

Writing in What is an Exchange? Ruben Lee comments on the importance of exchanges in general:

> These markets perform a wide range of economic and political functions. They offer a fora for trading, investment, speculation, hedging, and arbitrage. They serve as mechanisms for price discovery and information dissemination. They provide vehicles for raising finance for companies. They are frequently pivotal

1 HL Deb 11 January 2006 c180

> elements in the success of financial centres. They are used to implement privatisation programmes, and they often play an important role in the development of emergent economies.[2]

The stock exchange is at the heart of this system; allowing investment and fundraising to be safer, more liquid and cheap.

On its website the LSE describe its activities thus:

> London Stock Exchange Group (LSE.L) is a diversified international market infrastructure and capital markets business sitting at the heart of the world's financial community. The Group can trace its history back to 1698.
>
> The Group operates a broad range of international equity, bond and derivatives markets, including London Stock Exchange; Borsa Italiana; MTS, Europe's leading fixed income market; and Turquoise, a pan-European equities MTF. It is also home to one of the world's leading growth markets for SMEs, AIM. Through its platforms, the Group offers international business and investors unrivalled access to Europe's capital markets.
>
> Post trade and risk management services are a significant part of the Group's business operations. In addition to majority ownership of multi-asset global CCP operator, LCH Group, LSEG operates CC&G, the Italian clearing house; Monte Titoli, the T2S-ready European settlement business; and globeSettle, the Group's newly established CSD based in Luxembourg.
>
> The Group is a global leader in indexing and analytic solutions. FTSE Russell offers thousands of indexes that measure and benchmark markets around the world. The Group also provides customers with an extensive range of real time and reference data products, including SEDOL, UnaVista, and RNS.
>
> London Stock Exchange Group is a leading developer of high performance trading platforms and capital markets software for customers around the world. In addition to the Group's own markets, over 35 other organisations and exchanges use the Group's MillenniumIT trading, surveillance and post trade technology.
>
> Headquartered in London, with significant operations in North America, Italy, France and Sri Lanka, the Group employs approximately 4,700 people.[3]

1.2 The LSEG: recent history

The London Stock Exchange (LSE) is a public company like any other,[4] with shareholders and profitability as its guide. It is not a public institution with societal aims, although, it would argue, the role it plays in society is a key one and a vital cog in making businesses grow by directing investment towards them.

As a public company it has looked for commercial expansion both through the range of its products (the main index and subsidiary markets like AIM) and expansion abroad often via mergers. In July 1998

2 *What is an Exchange?* Lee, p5
3 LSEG website
4 A decision to demutualise was announced in 1999 and trading of shares in the LSE began in July 2000

LSE chief executive Gavin Casey revealed plans to form a "strategic alliance" with none other than Deutsche Borse.[5]

On its website the LSE publish a timeline of events over the last decade. It illustrates, if nothing else, the commercial nature of the LSE as a company apart from its functions as an exchange. The current London Stock Exchange Group was created in October 2007 it merged with Milan Stock Exchange, Borsa Italiana. An edited selection of events are shown below:

London Stock Exchange Group Timeline

October 2007

London Stock Exchange and Borsa Italiana merge, creating Europe's most diversified Exchange Group.

December 2008

London Stock Exchange Group and Oslo Børs announce strategic partnership including the provision of trading services to its equities, fixed income and derivatives markets.

December 2009

London Stock Exchange Group acquires majority stake in Turquoise and launches pan-European trading partnership with global investment banks.

January 2011

A strategic partnership is signed with the Mongolian Stock Exchange.

December 2011

London Stock Exchange Group plc acquires outstanding 50 per cent of FTSE International Limited, giving LSEG 100 per cent ownership and strategic control.

21 February 2012

Agreement with Google gives global users access to real-time 'last trade price' data for trades on London Stock Exchange and Borsa Italiana.

March 2012

LSEG agrees to acquire majority stake in LCH.Clearnet Group Limited.

April 2013

FTSE Group and TMX Group announce a definitive agreement to combine their fixed income index businesses in a new joint venture: FTSE TMX Global Debt Capital Markets.

May 2013

London Stock Exchange Group completes purchase of majority stake in LCH Clearnet.[6]

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5 Sunday Telegraph 11 February 2007, p85
6 LSEG website

The LSE has not always been the initiator of mergers, it has on occasion been the 'hunted' too. In 2006 and 2007 the LSE was subject to a hostile takeover bid by the American NASDAQ group which also prompted rival bids from Deutsche Borse and the Macquarie Group.

The current bid comes after a long line of previous successful and unsuccessful bids, for and by, the LSE set out in this Daily Telegraph article here.

Away from the LSE, merger activity amongst stock exchanges has been very common this century as a result of competitive pressures and technological advances. A graphic in the Financial Times (4 October 2013) show how 18 exchanges worldwide in 1999 had become just five in 2012 – EX, LSE, ICE, CME Group and NASDAQ OMX

1.3 The current merger

The current proposed merger between the LSEG and Deutsch Borse was approved by the shareholders of both companies in August 2016. The LSEG will be the minority partner in the new company although the merger is described as being 'between equals'. There is a full chronology of the merger process with accompanying official documents and other material on the LSEG website here.

The first announcement was made in February 2016 on the LSEG's website. The official notice began:

> Further to the recent movement in LSE's share price, the Board of LSE and the Management Board of Deutsche Boerse confirm that they are in detailed discussions about a potential merger of equals of the two businesses (the "Potential Merger" to form the "Combined Group").
>
> The Potential Merger would be structured as an all-share merger of equals under a new holding company. Under the terms of the Potential Merger, LSE shareholders would be entitled to receive 0.4421 new shares in exchange for each LSE share and Deutsche Boerse shareholders would be entitled to receive one new share in exchange for each Deutsche Boerse share. Based on this exchange ratio, the parties anticipate that Deutsche Boerse shareholders would hold 54.4 per cent, and LSE shareholders would hold 45.6 per cent of the enlarged issued and to be issued share capital of the Combined Group. The Combined Group would have a unitary board composed of equal numbers of LSE and Deutsche Boerse directors.
>
> The Boards believe that the Potential Merger would represent a compelling opportunity for both companies to strengthen each other in an industry-defining combination, creating a leading European-based global markets infrastructure group. The combination of LSE and Deutsche Boerse's complementary growth strategies, products, services and geographic footprint would be expected to deliver an enhanced ability to provide a full service offering to customers on a global basis.[7]

[7] LSE Website

In June 2016 the main offer and prospectus documents were published together with a summary ['powerpoint'] which includes some of the main points the LSEG wish to make, including claimed cost savings of €450million a year and 'revenue synergies' of, eventually, €250 million a year.

Industry-defining and value-enhancing combination

Strong Value Creation

- Combination enables shareholders of LSEG and Deutsche Börse to participate in the significant value creation opportunity through their interests in HoldCo
- Accretive to adjusted cash earnings for both sets of shareholders in year one[1]
- Deliver significant value creation through cost synergies of approximately €450m per annum to be achieved in year three post transaction close
- Revenue synergies of at least €250m per annum to be achieved in year five post transaction close, with approximately €160m achieved by year three
- Significant additional revenue growth opportunities possible

Compelling Strategic Rationale

- Create a leading global markets infrastructure group anchored in Europe
- Largest exchange group by total income with a diversified revenue mix by product and geography
- Address changing global customer needs in an evolving regulatory landscape
- Maintain and strengthen its customer partnership and pro customer choice principles
- Enhance both London and Frankfurt as domestic and international financial centres
- Support the development of the EU's Capital Markets Union through the Combined Group's commitment to SME markets and initiatives
- Create a leading venue for capital formation and the facilitation of economic growth
- Deliver a platform of choice for risk and balance sheet management, increasing safety, resiliency and transparency in global markets
- Create a leading information services business, providing innovative benchmarking in index and data products to inform decision-making across the investment life cycle
- Benefit from an enhanced global footprint and the creation of a platform for future growth in Asia and North America

The current bid comes after a long line of previous successful and unsuccessful bids, for and by, the LSE set out in this Daily Telegraph article here. At the most basic is the fact that the stock exchanges around the world are mostly (well the big ones at least) companies. In the case of a 'product' so similar as providing a trading platform it is simple to see that there could be money to be made by merging, premises technology sharing, fewer regulatory costs etc. There are lots of cross national mergers already. The LSEG is in a partnership with the Toronto SE. The US Nasdaq owns quite a few Nordic and Baltic exchanges. An online Investopedia article goes into more depth.

2. Can the merger be stopped?

In short, yes but there is no apparent groundswell to do so, yet.

The most important authorities that could block the merger are the UK Competition and Markets Authority (CMA) and the EU antitrust authorities. It does not appear as though the CMA has begun an investigation. For the sake of historical interest their Report into the previous attempted link up can be found here. Once formally notified of the proposed merger, the Bank of England and the Financial Conduct Authority would assess the proposal from a regulatory standpoint. The point about regulatory approval was addressed in an Answer in the Lords in April 2016:

> Once formally notified of the proposed merger, the Bank of England and the Financial Conduct Authority (as supervisors of the London Stock Exchange Group's UK-authorised subsidiaries) must assess the proposal from a regulatory standpoint.
>
> In addition the proposed merger must be approved by competition authorities and is subject to a range of other assessments including those of overseas regulators and shareholders.
>
> European Regulation No 648/2012 (EMIR) sets out detailed standards on the quality of collateral that a central counterparty (CCP) can accept, and includes a general requirement that the CCP can demonstrate to its supervisor that the form of collateral in question does not present unmanageable risk to the CCP. Furthermore, CCPs are permitted under EMIR to invest their collateral "only in cash or in highly liquid financial instruments with minimal market and credit risk."
>
> Any proposals for inter-CCP links would need to be assessed against relevant parts of EMIR by the Bank of England, as supervisor of LCH. EMIR requires that models used to set CCP margin requirements (and any changes to them) are validated by the CCP's supervisor. EMIR also requires that a CCP wishing to extend its business to additional products or services must obtain the authorisation of its supervisor.

The European Commission has begun proceedings however:

> On 28 September 2016, the European Commission announced the commencement of Phase II proceedings in connection with its review of the proposed merger between London Stock Exchange Group plc ("LSEG") and Deutsche Börse AG ("Deutsche Börse"). Separately, LSEG announced on 28 September 2016 its intention to explore a potential sale of LCH SA, LCH Group Limited's French regulated operating subsidiary, which is making good progress. Today, as part of the on-going EU Merger Regulation process, LSEG and Deutsche Börse confirm that they have received a Statement of Objections from the European Commission in relation to the proposed merger, reflecting a narrower scope of issues. LSEG and Deutsche Börse look forward to continuing to constructively engage with the European Commission and responding to any concerns raised.

In a subsequent announcement at the end of 2016, the Commission said that it was narrowing the scope of its investigation.

Concern over the merger has been heightened, like much else, due to uncertainty over the impact of Brexit on the City. There has been considerable speculation about what Brexit means for the City, from nothing will change to large numbers of jobs being lost.

If a government felt that there was something more than competition issues at stake with the merger, then the Government would act through the CMA in the first instance if it wanted to block the deal.

The national interest test

With respect to a national interest test – or objection – the following generally applies.

The *Enterprise Act 2002* effected a major reform of the control of mergers and takeovers, removing the decision-making powers of Ministers, save in defined exceptional cases, and passing this responsibility to the competition authorities – at the time, the Office of Fair Trading (OFT) and the Competition Commission (CC). Under the Act, the competition authorities are required to assess whether a merger should be prohibited on the basis of whether the merger can be expected to lead to a ***substantial lessening of competition***. The 2002 Act allows for the Secretary of State to intervene in mergers where they give rise to certain specified public interest concerns: specifically, issues of national security; media quality, plurality & standards; and, financial stability (under s58 of the Act). In these cases the Secretary of State may make an assessment of a merger purely on the grounds that it runs counter to the public interest, without deferring to the 'substantial lessening of competition' test, or they may give regard to both tests in coming to a final decision.

The procedure is set out in chapter 16 of the Competition & Markets Authority's guidance on mergers – attached.

Over the past few years there have been several occasions when a specific merger or takeover bid has resulted in a wider debate as to whether the law should be changed, to allow the authorities to apply a wider test when considering the potential costs and benefits of any merger – without, to date, any major reform: a Library note discusses this in some detail: *Mergers & takeovers : the public interest test*, 1 September 2016

Aside from purely UK authorities, the merger has to be approved by EU competition authority and the economic ministry of the German State of Hesse.

According to a Bloomberg article in September 2016, the German Minister said that where the exchange is, is not part of the decision process.[8] However, in February 2017, the same Minister seemed to indicate that the headquarters of the group would need to be in Germany:

[8] Bloomberg Markets September 2016

"The reason for the headquarters being in Frankfurt are crystal clear," Thomas Schäfer, finance minister of the state of Hesse, which must approve any deal, said. "Those involved in London must recognise, also in their own interests, that it would not be a good idea to keep the plans as they are now." [9]

[9] Digital Look Web Financial Group

3. Parliamentary comment

The UK Government has not indicated whether it approves or not of the proposed merger. It has stated in replies to numerous questions that there is a process to be gone through before the merger can be approved and it is content for that process to take its course.

Successive questions are frequently referred back to an answer in April 2016:

> HM Treasury, Financial Services
>
> HL7153
>
> To ask Her Majesty's Government whether they will review the possible consequences for financial stability of the consolidation of central clearing houses.
>
> Answered by: **Lord O'Neill of Gatley**
>
> Answered on: 01 April 2016
>
> European Regulation No 648/2012 (EMIR) establishes a strict supervisory framework for CCPs, which in the UK are regulated by the Bank of England.
>
> EMIR's requirements – which continue to apply in the event of a merger or change of control of a CCP – include that a CCP must be sufficiently well-resourced to withstand extreme market events, including the simultaneous default of its two largest clearing members.
>
> In the event of a qualifying change of control the Bank of England must under EMIR also assess the suitability of the proposed acquirer and financial soundness of the proposed acquisition.
>
> Copies of the Bank of England's 2016 report on supervision of financial market infrastructures were laid before Parliament on 4 March and are available in the House library.

In the Commons the standard response appears to be:

> HM Treasury, London Stock Exchange: Deutsche Borse
>
> 34500
>
> To ask Mr Chancellor of the Exchequer, what assessment he has made of the implications for economic security of the proposed merger between the London Stock Exchange and Deutsche Börse.
>
> A
>
> Answered by: **Harriett Baldwin**
>
> Answered on: 25 April 2016
>
> Once formally notified of the proposed merger, the Bank of England and the Financial Conduct Authority (as supervisors of the London Stock Exchange Group's UK-authorised subsidiaries) must assess the proposal from a regulatory standpoint.
>
> In addition the proposed merger must be approved by competition authorities and is subject to a range of other assessments including those of overseas regulators and shareholders.

4. Press Articles

The following press articles are relevant to the debate. Some articles may require a subscription.

Deutsche Börse CEO talked to Merkel adviser about LSE tie up before share purchase, Spiegel reports
Financial Times, 10 February 2017

Boardroom backing for Deutsche Borse boss over share purchase
Belfast Telegraph, 7 February 2017

Deutsche Börse chief probed over €4.5m share deals ahead of LSE merger talks
Guardian, 2 February 2017

LSE sells French clearing unit to Euronext for €510m
Financial Times, 3 January 2017

London Stock Exchange offers to sell European clearing business ahead of full Deutsche Boerse merger probe
Belfast Telegraph, 28 September 2016

Mergers: Commission opens in-depth investigation into proposed Deutsche Börse/LSE merger
European Commission, 28 September 2016

Deutsche Börse wins shareholder approval for LSE merger
Financial Times, 26 July 2016

LSE and Deutsche Börse say proposed merger can withstand Brexit
Guardian, 4 July 2016

London Stock Exchange shareholders vote to approve Deutsche Borse merger
Belfast Telegraph, 4 July 2016

London Stock Exchange and Deutsche Boerse agree £21bn 'merger of equals'
Telegraph, 16 March 2016

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