The merger of the Frankfurt and London stock exchanges

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The merger announced May 3 combining the Deutsche Börse Frankfurt (Frankfurt Stock Exchange) and the London Stock Exchange (LSE) will create the biggest stock exchange in Europe. The new entity, to be named International Exchange (iX), will be the fourth largest stock exchange in the world following the New York Stock Exchange (NYSE), Nasdaq and Tokyo.

Most commentators see the Frankurt-London link-up as being a "first step towards a global stock exchange" which might well result in a unified pan-European stock market within the next two years. The British newspaper the *Guardian* writes: "A single global stock market is now one step closer to reality."

But this increasing concentration is also intensifying rivalries within Europe and between Europe and the United States. In the same report quoted above the *Guardian* warns: "The merger of the London Stock Exchange and Frankfurt's Deutsche Börse might be a blow to the former." However, it then goes on to say: "but that's no reason to stand in the way of globalisation." Other commentaries place more emphasis on the emergence of a European rival to counter market domination by the NYSE.

The new iX will have its headquarters in London, and will trade traditional stocks and shares from Germany and Britain. Fifty-three percent of European trading with blue chip stocks (the shares of major corporations that define the stock price indexes) will then take place at the new exchange.

Frankfurt will be the location for trading with stocks from the German "Neuer Markt" ("New Market"—the Frankfurt high-tech stock exchange) and its London counterpart, "techMark". Trade with these high-growth equities will be combined in a joint company with Nasdaq, which will hold 50 percent of the new company's shares. Nasdaq's trade with technology stocks and high-risk growth equities has made it the world's second largest stock market location next to the NYSE in terms of trade volume.

In combination with Nasdaq, the new stock exchange will account for 81 percent of Europe's booming high-tech growth market, putting it in an unassailable position, at least as far as Europe is concerned. The new combination also aims to make trading with the major stocks in this sector possible 24 hours a day in the near future. Nasdaq already plans to open a trading location for this in June in Tokyo which will be integral to the new structure.

Competition for the dominating position in the European—and, in the long run, worldwide—stocks and securities market is mainly being fought out at the level of the technical trading systems' cost and stability. In this cut-throat competition, the essential question is which stock exchange has the most stable and cost-efficient system, enabling it to prevail over others.

There are 40 stock exchanges in Europe with a total annual administration cost of more than one billion US dollars. This is financed by the stock buyers and sellers in the form of fees and commissions. The big banks and investment funds, in particular, which account for most of the trading, are no longer prepared to accept stock exchanges organised on a national basis in view of new technological developments and the international character of their business operations.

Germany's Deutsche Bank AG, for instance, incurs expenses in double- and even triple-digit millions for its connections to various stock exchanges. The high cost is due to the different technical systems, settlement methods and national regulations applied in these exchanges. Leonhard Fischer, the Dresdner Bank board member responsible for stock trading and, as of May 8, the deputy chairman of Deutsche Börse AG, stated on this topic: "We need two, maybe three stock exchanges in Europe at which we can trade inexpensively, quickly and unbureaucratically."

This is why the search has been on for some time now to find alternatives to the existing stock exchange systems. One innovation rapidly making inroads is the introduction of so-called electronic communications networks (ECN's) modeled on Nasdaq, with which trading is done entirely by computer network.

The Goldman Sachs and J.P. Morgan investment groups, Deutsche Bank and Dresdner Bank are cooperating in the introduction of an alternative system called Tradepoint, which will go into operation this July running 230 of the biggest European stocks. Another investment group, Morgan Stanley Dean Witter, and the Swedish OM Group, which runs the Stockholm stock exchange, are scheduled to introduce their Jiway system in September. According to them, Jiway will be the trading platform for more than 6,000 European and American stocks.

Last November, Nasdaq announced plans to establish a separate pan-European market for high-growth securities in London which was to pool most of European trading in this sector. In response to this, the European stock exchanges intensified their efforts to create a European exchange to counterbalance Wall Street's dominating position. There is increasing agreement that "the classic stock exchange organised on a national basis is a phase-out model in view of the convergence of the money markets."

In late March, the Paris, Amsterdam and Brussels stock exchanges announced, after lengthy negotiations, that they would join up to form Euronext, which was to be the second largest European stock exchange after London and the axis for a new European mega-exchange. They also hoped to put the up-and-coming Frankfurt exchange in its place this way. When these merger plans were announced, Jean-François Théodore, the designated Euronext chief, stated that the new combination would win back substantial business from London and Frankfurt. The merger of the London and Frankfurt exchanges has now shattered these hopes.

The new iX has two main advantages. First its size, which already now has convinced the Milan and Madrid stock exchanges that they should join the new union as soon as possible, and which will attract a number of other small exchanges. Second, Frankfurt's successful Xetra trading system, which will be the general trading platform for iX.

The technical system was an essential aspect in achieving the London-

Frankfurt merger. First negotiations had already started in July 1998, but were called off in December 1999 because of nationalistic moods prevailing in London's City at that time. The London stock exchange was at that time still able to rely on its hitherto undisputed dominant position in Europe.

But London's perspective for the future rapidly deteriorated under growing international pressure. Britain's SETS trading system is considered to be outdated—only last April 5 it broke down, paralysing securities trading for seven hours. The expense and effort of developing a new, internationally competitive system didn't bear considering, so it was merely a matter of time before London would fall back in the race for supremacy.

This was a trap Werner Seifert, Deutsche Börse's chairman since 1993, did not fall into. Seifert realised early on that "the technical systems are the decisive factor in the competition between stock exchange locations", and started laying the groundwork accordingly. The staff of this former partner of McKinsey's, the management consultancy notorious for its job-cutting policies, nicknamed him "Rambo" because of his unscrupulousness in attaining his goals. It is with such methods that "the Deutsche Börse chief has taken a medium-sized exchange to the brink of European domination", wrote the *Financial Times*.

Seifert focused on "electronification" right from the start, i.e., on the development and introduction of computer systems with which trading could be handled at the lowest possible expense. Traditional floor trading has become a matter of secondary importance in Frankfurt. Seifert himself calls it a "folklore event" that would be more appropriate as a museum exhibit. This is a genuine reflection of his entire approach which in recent days has evoked lavish praise in the financial press on both sides of the English Channel.

For instance, from the *Financial Times*: "No candidate from Germany's then somewhat conservative corporate world would have injected a spirit of change so effectively".

It is certainly true that Seifert has succeeded in positioning Frankfurt as a top European stock exchange in terms of profitability through the development of Xetra and the merger of Frankfurt's futures exchange with the Zurich exchange. The result of that merger, Eurex, is now in the No. 1 position worldwide, having far surpassed the traditional Chicago futures exchange. If it were to be quoted at the stock exchange tomorrow, Eurex's stock value would be twice as high as that of the London Stock Exchange, even though the LSE's trading volume is twice as high as that of Frankfurt.

Because of its great stability and—what is particularly important in times of crisis—its operational load capacity, Xetra will be a core element of the new exchange. Now considered to be one of the trading systems of choice for the future, it is already in use at the Vienna, Helsinki and Dublin stock exchanges, and will soon be installed in Chicago.

The merger with Deutsche Börse reflects a shift in opinion in London's finance centre, the City, where the opinion now prevails that the traditional policy of manoeuvring back and forth between the economic interests of the US and Europe has become too dangerous.

The bleak outlook for the London stock exchange has caused London's financial world to revise its previous "arrogant" attitude and even agree to a 50-50 "merger of equals". When the merger negotiations first started, the London stock exchange was still insisting on holding 76 percent of the shares in the new exchange.

Cries of alarm, such as a headline in the *Daily Telegraph* calling the whole thing "a German-inspired attempt to introduce the euro in Britain through the back door", have made practically no impression at all on the City, where enthusiasm for the euro is rapidly growing. Taking the same line as the *Guardian* article quoted above, the City's official mouthpiece, the *Financial Times*, calls for an end to London's "paralysis".

Preparations to this effect have been ongoing since the beginning of the year. As a first step, the LSE's membership structure, which had been in existence for 199 years, thus making it the City's oldest institution, was transformed into a shareholder organisation in March. An overwhelming majority of the 298 members—consisting mainly of bankers and stockbrokers—voted in favour of the plan to re-establish the LSE as a profit-oriented corporation.

This was followed one month later by the retirement of Sir John Kemp-Welch and the appointment of 57-year-old Don Cruikshank as the new LSE chairman. The financial community doesn't regard Cruikshank as being "one of us". As the former chief regulator of the British telecommunications market for many years he was seen as a member of the "old" reformist school. But after making a complete break with his former opinions by publishing a "devastating" report on the lack of competition among British banks, he is now touted as the man who will whip the City into shape for international competition. His old ties to the government and government authorities are seen as his main trump cards.

Cruikshank openly propagates subordinating British interests to those of Europe, or at least pursuing British interests within a European framework. In formulating this approach, he stated: "The patriotic, nationalistic background to this is really quite unfortunate.... For Europe as a whole in this area, learning to set aside national interests is quite critical." The *Financial Times* commented: "The London Stock Exchange's more active members wanted someone who could shake it out of its complacency."

This loosening of ties to the US by London's financial world will add to the tensions that have arisen due to the increasingly independent stance taken by Europe, which now also wishes to play a more important role in the global finance market. Despite general approval by the US media for the new "European stock exchange", which will enable 24-hour trading for the major American investors, warnings are now being voiced that the New York Stock Exchange must bring forward an adequate response to this challenge.

Although the NYSE has an annual revenue that is nearly three times larger than that of the new iX—$11.24 billion (in 1999), compared to iX's $4.3 billion—New York Senator Charles Schumer demanded in the May 5 issue of the *New York Times* that the NYSE must also be transformed into "a shareholder-owned, profit-driven, bottom-line company". Schumer went on to warn: "The exchange cannot waste any time in adapting to the new world. That's what happened in Chicago. Now it's No. 2."