

THE REGULATORY TIES THAT BIND MARKETS:  
THE POLITICAL ECONOMY OF CROSS-BORDER INTEGRATION  
IN THE EXCHANGE INDUSTRY

by

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## ABSTRACT

This dissertation considers cross-border integration from the perspective of financial market regulators. It analyzes market authorities' responses to the phenomenon of cross-border merger and acquisitions in financial services, particularly involving exchanges. In some instances, regulators have approved these proposals, but in others they have intervened, even blocking proposals in high-profile decisions. This variation is puzzling and cannot be accounted for by standard explanations, including regime type or political pressures on regulators. When do officials interfere in the market for corporate control of financial service firms, and why?

To explain this variation, the dissertation develops a theory of regulator dependence that focuses on the relationship between regulators and firms. The theory considers the conditions under which regulators' preferences are insulated from social and political pressures, where regulators can act on their own preferences regarding integration. These preferences are a function of regulators' dependence on firms' cooperation and compliance to deliver on desired public policy outcomes. Mergers are threatening where regulators depend on a merging firm, and in these contexts regulators interfere with integration proposals. This dependence is a consequence of historical policy outcomes shaping the structure of the market and the allocation of regulatory authority. Empirical analysis of ten cases corroborates the theory's predictions.

The theory of regulator dependence establishes the analytical and empirical significance of considering regulators' discrete views about market integration in order to explain certain financial market outcomes. In doing so, the dissertation contributes to our understanding of the conditions under which cross-border market integration is more or less politically feasible, and adds nuance to the established view that the historical development of domestic markets has significant and systematic effects on international market integration.

## PREFACE

This dissertation is original, unpublished, independent work by the author, Matthew Joseph Gravelle.

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## **CHAPTER I**

### **INTRODUCTION: WHEN DO REGULATORS INTERVENE IN THE MARKET FOR CORPORATE CONTROL?**

#### **Introduction**

On 9 February 2011, Xavier Rolet and Tom Kloet, respectively the CEOs of the London Stock Exchange Group and Canada's TMX Group Inc., announced a merger between their companies. The proposed deal would have created an entity with ownership of the London, Milan, Toronto, Montreal, and Vancouver stock exchanges (as well as other key assets) – the second biggest exchange company globally, by market capitalization of their listed companies. By June of the same year, and only four months after the deal was announced, the LSE had retreated by withdrawing its proposal in the face of an anticipated rejection by TMX shareholders, who were judged unlikely to provide the necessary two-thirds support.

It was not, however, because TMX shareholders preferred the status quo that the London bid failed. A counterbid for TMX emerged, and shareholders instead voted to approve the potentially more lucrative (and also more complicated) purchase of TMX by the Maple Acquisition Corp., a consortium of thirteen of the largest Canadian financial institutions – including four of the six largest Canadian banks, as well as several Canadian pension funds and private equity groups.

That this deal was quickly cobbled together is testament to the long-term value those Canadian financial institutions saw in the TMX, and their ability to find the resources to build a credible counter-offer. It is also testament to the hard work of the legal and regulatory teams on all sides, who were able to navigate the competition concerns that emerged as the major users of

Canada's critical financial infrastructure – and the part-owners of its main competitor – sought to buy it.

That, at least, is a conventional account of the LSE proposal and Maple counterbid: a deal settled by a more lucrative counter-offer in the open market for corporate control, absolving politicians and officials of the need to openly pick sides and arbitrate. As a surface level analysis it is not without merit.

As this dissertation will make clear, however, public sector concern about who owns and operates large financial infrastructure firms is a critical factor shaping outcomes in the market for corporate control of those entities. It is a primary contention of this dissertation that the fate of these commercial proposals cannot be fully understood by reference to market forces alone. And indeed, while the Canadian case may be somewhat unique in that the relevant political interference there operated below the surface and outside of the public spotlight, it is not unique in featuring political wrangling over the future of an exchange firm. Since 2001 there have been several instances of both outright and subtle exercises of public interference in decisions about the ownership and operation of private exchange firms, including:

- The European Commission blocking a proposed merger between Frankfurt's Deutsche boerse and the New York Stock Exchange in 2012;
- The Australian government blocking a proposed takeover of the Sydney-based ASX by SGX, the Singaporean exchange operator, in 2011;
- A history of failed mergers involving the London Stock Exchange that is replete with political intrigue, including twice-failed moves between the LSE and Deutsche boerse (2001 and 2005), and between the LSE and New York-based NASDAQ and Australian bank Macquarie (2005).

In short, given this broader pattern of public involvement and interference in exchange mergers, it was probably not coincidental that the Canadian consortium making a counterbid for TMX opted for nationalistic symbolism and called itself “Maple”. Indeed, given the central role of exchanges in a country’s economy, it can be asked whether failed mergers can simply be chalked up to nationalism.

At the same time, however, there are notable cases of cross-border mergers in the exchange industry that have not presented intractable issues to politicians or public officials – and the proposed mergers have received regulators’ approval as a result. The pan-European merger creating the Euronext conglomerate in 2001, London’s purchase of Milan’s Borsa Italia, and the more politically contentious transatlantic NYSE-Euronext (2007) and NASDAQ-OMX (2007) mergers stand out as examples of this latter, successful kind of proposal, among several others. Moreover, the deals just mentioned are notable because it was not initially obvious that politicians or regulators - particularly in Europe - were especially inclined to allow the deals to go through, as scepticism and concern on the part of officials seemed to present early obstacles to cross-border integration involving these firms.

What explains why some cross-border mergers involving countries’ financial markets infrastructure fail as a result of public interference while other mergers are approved? What makes some types of cross-border commercial deal-making more problematic for public officials than others? More fundamentally, when do financial market regulators allow deeper cross-border integration between firms, and when do they impede it?

To answer these questions, this dissertation considers the role of exchanges not only as private commercial entities, but also key players in a broader public policy network of actors. The dissertation embarks from the premise that exchanges – like other large financial service

firms – are intimately connected not only with the public policymaking process, where they are very influential (Lindblom, 1977; Gould, 2003; Eberle and Lauter, 2011; Pagliari and Young, 2014; Young and Park, 2013), but also with the delivery and execution of a wide array of public policy goals. Banks, exchanges, insurance providers, asset and fund managers, and a wide range of intermediaries often play crucial roles distributing credit, risk, and capital through the economy (Mugge, 2013). These roles mean that financial firms are heavily involved not only in policy development but in each stage of the policy process, from development through to implementation and delivery. Indeed, officials often need the compliance and cooperation of financial service firms in order to meet their domestic policy targets, with the result that public officials quite rationally seek to have influence and a significant measure of control over such firms' private undertakings.

However, as the above cases suggest, domestic officials are often faced with the prospect of overseeing the domestic subsidiary component(s) of multinational financial service conglomerates, as a result of cross-border mergers and acquisitions. How and when do financial service firms that operate in multiple jurisdictions complicate the delivery of domestic policy goals for domestic officials? How do officials respond?

In recognition of this question, a literature on the political causes and consequences of cross-border ownership structures in the banking sector is beginning to emerge (Epstein, 2014a, 2014b; Goyer and Valdivielso del Real, 2014); while the exchange industry has not yet been considered, it is instructive to do so. Notably, it is an industry which has undergone dramatic changes in the last two decades. First, exchanges have largely “demutualized” and become publicly-traded firms with shareholder-value driven commercial incentives. Second, the incumbent national exchanges have engaged in several waves of consolidation that have led to exchange

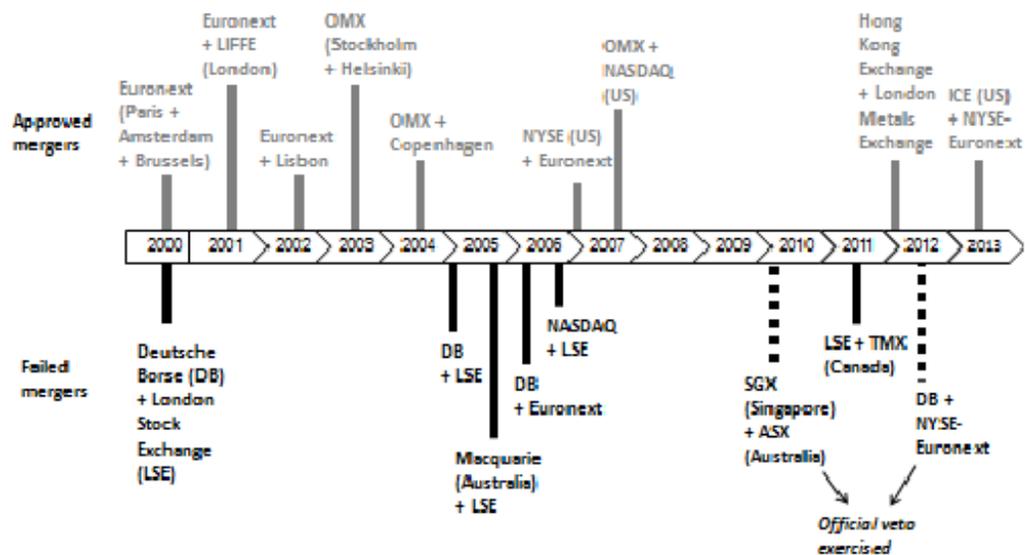
conglomerates: holding companies that own and operate multiple exchanges and trading platforms, and offer ancillary market services (like data provision, or “post-trade” services including transaction reporting, clearing and settlement). Many of these conglomerates are multinational, meaning they operate trading venues and related infrastructure in multiple jurisdictions, and interface with multiple sets of regulatory authorities as a result.

Securities’ trading is a heavily regulated industry, and so mergers and acquisitions involving exchanges can generate significant regulatory challenges. This is particularly true where mergers are proposed on a cross-border basis, involving the intermingling of exchange infrastructure, firm management, and public officials from multiple jurisdictions, and lessening each domestic regulator’s exclusive oversight over the firm. Securities market transacting as well as securities regulation are often strongly embedded within national jurisdictional boundaries and localized capital markets, even though market participants and their capital can be highly mobile (Pownall et al., 2014; Wojick, 2011). Moreover, exchanges and related facilities are often integral components of a domestic economy’s financial and even social security systems. Cross-border integration thus presents officials with an acute dilemma, and one that is familiar to political economists: how to navigate the twin imperatives of a) international financial integration and b) the delivery of domestic policy goals (Garrett, 1999; Clift and Woll, 2012; Epstein, 2014a).

Interestingly, market authorities appear to navigate these twin pressures differently.

Table 1

*Major approved and failed merger and acquisition proposals since 2000*



Looking at this universe of cases, there are several puzzling features of the recent history of cross-border merger and acquisition proposals involving financial infrastructure firms.

### **Varying merger outcomes: a puzzle beyond the reach of standard explanations**

First and most obviously, there is variation in whether public decision-makers interfere with, block or allow cross-border mergers and acquisitions involving financial infrastructure firms. This in itself is an interesting observation: the financial exchange industry is understudied in both international and comparative political economy scholarship to date (see Chapter 2), and knowing more about the political dynamics that underpin public governance in this large and systematically-important sector is worthwhile from an empirical perspective alone.

What makes these varying outcomes *theoretically* interesting is that both blocked and approved mergers have been beset by multiple public concerns, of both a policymaking and political nature, but they have not been resolved in the same way. This becomes clear upon even

a cursory read of the media coverage accompanying each proposal, with headlines that point to the many regulatory and political issues as well as shareholder and stakeholder concerns that have been activated in the context of merger proposals. Indeed, these proposals have activated a complex and overlapping mixture of concerns about national competitiveness, market development, market structure, industrial policy, and regulatory oversight – indeed, concerns that are difficult to disentangle for the purposes of making efficient and accurate causal claims. Importantly – and confusingly – many of the same concerns that have served to derail failed proposals also became salient during merger proposals that were eventually allowed: in both successful and failed proposals, public sector stakeholders can be observed worrying about their regulatory oversight, the impact on their broader policy and supervisory efforts, and the implications for the wider domestic capital market. And yet, in some cases these concerns have proven insurmountable and have led to impeded and failed mergers. In other cases the opposite was true.

Adding to this puzzle is the observation that merger proposals appear to instigate regulators to take different types of steps to shore up their own control over the entities under their supervision. Across cases there is variation in the degree to which – subsequent to the merger proposals – public officials have worked to implement measures to maintain domestic control over their piece of exchange infrastructure, in some cases blocking the merger, as is evident, but in others merely putting in place memoranda-of-understanding with foreign regulators, or writing certain conditions into the bylaws of the merging firms themselves (and in at least one case, NASDAQ-OMX, not doing much of anything at all). In other cases, officials take steps to remediate certain perceived gaps in their control and oversight after failed merger proposals, i.e., on a forward-basis. It is not immediately obvious why measures that are ‘good

enough' in some jurisdictions are deemed insufficient in others, or why regulators take steps to change the way in which they exercise oversight even when mergers have been blocked, or failed.

Beyond the general puzzle regarding variation in merger outcomes, it is also unexpected to see public authorities interfere (in some cases rather aggressively) in the market for corporate control of financial service firms. At a fundamental level, strong examples of public intervention are interesting because such action can be costly. This is true both for normative reasons, because intervention contravenes beliefs about the legitimate limits of state action that have been dominant for most of the post-Cold War period (Buch-Hansen and Wigger, 2010), but also because it could be anticipated to generate material consequences, particularly if it makes private firms more reticent to invest or transact in the jurisdiction going forward (Dinc and Erel, 2013).

Additionally, it is interesting to note that regulatory authorities themselves enabled the creation of private, commercially-oriented financial infrastructure firms over the last two decades: the shift from the mutualized stock exchange utility that operated for its members benefit to today's publicly-listed and commercially-driven exchange firm operated by holding companies was sanctioned and/or approved by national regulatory authorities. Blocking a typical commercial transaction by such a firm after the enabling its creation is therefore unexpected. It is more difficult to treat such an entity as a national utility once it has been fully privatized and relegated to market forces, both at the level of rhetoric and credibility as well as through the use of mechanisms of regulatory control. Indeed, contrary to the cases observed here, it is reasonable to expect that public actors – particularly in liberal economies – would be highly reticent to develop a reputation for unpredictable interference in capital markets they have worked to build, or over the ownership of private commercial entities they have allowed to

proliferate. Despite these considerations, interference in the market for corporate control of these infrastructure firms has been repeatedly observed over the last decade and a half.

This is particularly interesting because the interference does not vary as predicted by the dominant typologies in political economy that distinguish between jurisdictions in terms of their economic or institutional configurations. For instance, there is a well-developed approach in the political economy of trade based on the Heckscher-Ohlin (HO) and Stolper-Samuelson (SS) models in economics. These approaches consider the relative factor endowments – land, labour, and capital – of different economies and predict the distributional implications of moves to eliminate barriers to cross-border trade and the policy choices that are likely as a result (Rogowski, 1987; Hiscox, 2001). At the most basic level, such approaches contend that the ‘natural’ endowments of an economy shape both its approach to international integration, in a manner that is not wholly dissimilar to a Wallersteinian world systems approach, and the subsequent implications of that integration. The key inference here is that capital-scarce economies ought to respond in similar ways when confronted with the prospect of deeper financial integration with a more developed jurisdiction – indeed, there ought to be strong incentives for the less-developed or smaller market in any integrating dyad to block financial market integration in order to protect the privileged position of domestic holders of scarce capital.

Empirically, however, there is no consistent approach observed by the smaller, less-developed markets in the mergers observed in this dissertation. It is important to note that none of the jurisdictions considered here would fit the ‘capital poor / labour rich’ economy type typically operationalized in the HO or SS models, in that they are all rich, developed, OECD states. That said, in many of the mergers there is a clearly dominant and clearly subsidiary

market, particularly between the US and the European markets (where capital markets are less developed than bank-led finance), and between Canada and the UK. In these examples the smaller, less developed jurisdictions do not respond in any dominant way to the merger, but rather can be observed supporting and blocking the proposals, respectively. The relative factor endowments typology does not provide leverage over the observed outcomes in the market for corporate control of exchanges.

The same is true of more institutionally-derived typologies. From a Varieties of Capitalism (VOC) perspective, or even a related legalistic perspective that emphasizes culturally-rooted differences in legal systems across capital market systems, the observed variation is hard to explain (Roe, 2003). The small literature on the comparative politics of rules governing the market for corporate control (Callaghan and Hopner, 2005; Gourevitch and Shinn, 2005) also falls short. Contrary to the expected systematic variation across the VOC and related corporate governance and legal system types, interference in exchange merger plans is not typically observed in coordinated or *dirigiste* systems where it might be more politically legitimate and/or expedient for public officials to step in (Zysman, 1983; Hall, 1986; Callaghan and Hopner, 2005; Gourevitch and Shinn, 2005; Callaghan and Lagneau-Ymonet, 2012; Callaghan, 2014). Indeed, countries whose officials might be expected to oppose mergers and act on that opposition, particularly French officials with a track record of doing so, have generally supported or at least not impeded mergers involving the Paris bourse at some junctures (Callaghan and Lagneau-Ymonet, 2012; Callaghan, 2014) while, at other points in time, they have taken steps to re-establish a level of national control over the exchange; similarly, officials from nominally “liberal” countries including Canada, Australia, and even the UK, have both contradicted expectations by working to impede mergers, and have also approved them with little-to-no

fanfare, as in the US. This suggests that something is at work beyond the type of capitalist system, or even the dominant model of financing in the economy (Zysman, 1983).

Moreover, other established political science approaches to explaining international market integration outcomes fail to predict outcomes, notably views that consider various societal pressures on decision-makers. Interference does not appear to be an example of endogenous protectionism (Milner, 1988; Magee et al., 1989) or successful lobbying on the part of financial interest groups with preferences over integration (Mugge, 2006). First, exchanges are negligible employers on their own, giving politicians limited incentives to interfere for electoral reasons; and where politicians have been involved, their opposition or support has been inconclusive, in that the views they express are often discordant and ultimately secondary to the efforts undertaken by veto-wielding regulators. Second, both the direction and the impacts of interest group lobbying regarding exchange mergers are indeterminate. Where lobbying may be observed, it either pulls policymakers in multiple directions simultaneously, as in France and Canada during notable merger cases there (Erman, 2011; Simon 2011a; Callaghan and Lagneau-Ymonet, 2012), or is ineffective in achieving its targets, as in Australia (Smith and Azhar, 2011) as well as in Europe (Barker and Grant, 2011; European Commission 2012a, p. 8). As the case studies elaborated in this dissertation demonstrate, it is simply not possible to explain outcomes as reflecting the preferences of either electorally-motivated political actors or rent-seeking interest groups.

System-level explanations for firm and market integration and/or harmonization also fall short (Gilpin, 1975, 1976; Krasner, 1976; Andrews, 1994; Helleiner, 1994; Drezner, 2007). The opportunity-cost incentive to integrate with a substantial foreign market did not appear to motivate Canadian or Australian authorities who blocked mergers with London and Singapore,

respectively, although it has some purchase in the case of French authorities allowing a tie-up with New York. In the opposite direction, the mercantilist fear of *losing* productive capacity and value through a link with a larger and more powerful foreign market – not dissimilar to the relative capital endowment perspective considered above – is also not observed in all decisions. For example, while Canadians certainly worried about the future status of Canada’s primary exchange firm under the control of a more powerful London-based entity (Legislative Assembly of Ontario, 2011a), that does not explain why the French and Dutch allowed New York to take control of their bourses.

Given that existing institutional, societal, and systemic explanations are unable to account for authorities’ decisions in an efficient manner, it is worth considering the potential explanatory value in looking at the preferences and actions of market authorities themselves – what regulators independently think about firm-level integration involving exchanges, and why.

### **A regulatory explanation for merger outcomes: the theory of regulator dependence**

To account for these puzzles, this dissertation considers the political economy of cross-border mergers in the world of financial infrastructure firms from the point of view of the firms’ regulators. It develops an explanation that focuses on regulators’ approach to these mergers as its primary analytical concern. Regulators’ approach to mergers is modelled as a function of their impact on regulators’ power and capacity, due to the ways in which territory, jurisdictional boundaries, and statutory reach are affected – and confused – as a result of cross-border integration (cf. Newman and Posner, 2011; Brummer, 2012).

In taking regulators’ preferences as *sui generis* – i.e., not dependent on exogenous influences, including the influence of their political principals and/or the firms that they regulate – the

dissertation makes a strong analytical assumption that requires some justification. It therefore develops in detail the conditions under which regulators may be more or less insulated from these everyday pressures: first, when politicians with electoral incentives either lack or choose not to activate powers of their own to veto a merger (that is, where regulators are institutionally privileged veto-wielding actors); and where firms' lobbying activities are either absent or, as is more often true in the cases analysed here, multi-valent, disorganised, and/or simply ineffective. In both these instances, the empirical observation of politicians voicing concerns about a merger and firms lobbying for an outcome they prefer is not taken as *prima facie* evidence of a captured regulator, or a regulator lacking in independence. Indeed, these observations may co-exist with the broader conditions for regulatory insulation and thus a meaningful degree of autonomous regulator action.

Where regulators' preferences are indeed *sui generis* due to insulation, the theory expects outcomes to be driven by the institutional context within which regulators and regulated exchange firms interact. The theory thus proceeds through three sets of casual mechanisms.

First, for several interrelated reasons, the costs to regulators of overseeing and securing the compliance of a cross-border firm are higher than the costs of overseeing and securing the compliance of a domestic firm. This gives regulators incentives to block cross-border consolidation involving the firms they oversee.

Why, then, do regulators not block all mergers? For authorities other than competition officials with a mandate to structure the market, interfering in the market for corporate control is a drastic and potentially costly step that is likely to be deployed only when the stakes are high (Dinc and Erel, 2013; Thatcher, 2014). Those stakes are a function of *regulator dependence*, which is both a key concept and the independent causal variable in the theory: it is defined here

*as the degree to which market authorities require the compliance and cooperation of private firms vis-a-vis their commercial undertakings so that authorities can realize their mandates and achieve their policy goals.* There are three possible ways in which regulators can be dependent on private exchange firms: to deliver needed capital market infrastructure, to monitor and police private market conduct, and/or to deliver on some broader set of public policy commitments. The higher the overall level of regulator dependence, the more likely authorities are to engage in regulator dependence and block a cross-border merger.

Finally, the dissertation theorizes that the level of regulator dependence is a legacy of antecedent policy developments relating to market structure in the exchange industry and the allocation and structure of regulatory authority. In particular, the theory links high levels of regulator dependence to antecedent market structure policy outcomes leading to a) a single-firm dominant market structure and/or b) an exchange firm that is vertically integrated across multiple business activities; and to antecedent institutional developments that have resulted in c) multiple regulatory authorities with an oversight role vis-à-vis the merging exchange firm and/or d) the delegation of self-regulatory authority to the exchange firm. This suggests that the depth of international integration that is politically feasible in the exchange industry is not solely determined by the preferences of large and powerful market actors, or the inevitable gravity of large and powerful markets. Instead, integration decisions can be driven by regulators' preferences, which are in turn shaped by the domestic configuration of market structure and the oversight of the market (cf. Farrell and Newman, 2010; Spenzherova, 2014).

The dependent variable that is explained in this dissertation is regulators' response to mergers proposals involving exchange firms. At the most fundamental level, this is a binary variable: is the regulatory response positive (i.e., approve; stand back to allow it to go through;

gain comfort after initial concern) or negative (i.e., block or intervene in more tacit ways)? The theory explains the observed values on this variable as a function of regulator dependence, as this dependence is therefore the independent variable that does the most significant causal work in the dissertation. Dependence is itself a condition determined by existing configurations of power, which are antecedent conditions that subsequently structure – and institutionalize – certain regulator-firm relationships. The causal linkages between these antecedent configurations and the subsequent degree of dependence are elaborated in detail in the theoretical chapter, but the basic flow of the theory – from historical policy questions to institutionalized conditions to the degree of dependence and costliness, and finally the expected response are summarized in the following table, which flows causally from left to right:

Table 2

*Summary of the causal logic of the theory of regulator dependence*

<b>Historical policy issue</b>	<b>Antecedent Conditions</b>	<b>Independent variable</b>	<b>Costliness of merger to regulators</b>	<b>Expected regulatory response</b>
Overall exchange market structure	Single-firm dominated market structure	High degree of regulator dependence	High	Negative
	Competitive market structure	Low degree of regulator dependence	Low	Positive
Exchange firm structure	Vertically integrated exchange firm	High degree of regulator dependence	High	Negative
	Non-vertically integrated exchange firm	Low degree of regulator dependence	Low	Positive

Historical policy issue	Antecedent Conditions	Independent variable	Costliness of merger to regulators	Expected regulatory response
Structure of public regulatory authority	Authority dispersed across multiple institutions	High degree of regulator dependence	High	Negative
	Authority concentrated in single institution	Low degree of regulator dependence	Low	Positive
Allocation of regulatory authority	Authority delegated to exchange firm	High degree of regulator dependence	High	Negative
	Authority retained within public institutions	Low degree of regulator dependence	Low	Positive

Finally, it is worth noting at this juncture that there are many permutations within the broad categories of positive or negative regulatory responses – i.e., approved mergers with/without memoranda of understanding, approved mergers with/without regulators being assuaged by certain control-enhancing policy innovations, or blocked mergers with/without subsequent policy steps to increase officials’ powers vis-à-vis private firms. These are not each dependent variables, but rather critical pieces of evidence that subject the theory to important and nuanced tests. Furthermore, they add empirical richness to the cases and in some cases lead to additional research questions that are identified in the dissertation’s conclusion.

**Implications of the theory**

The theory of regulator dependence yields a significant and counter-intuitive finding: contrary to perspectives that emphasize the structural power of the corporate sector over public

actors (Lindblom, 1977; Gould, 2003; Tsingou, 2006; Underhill and Zhang, 2008; Culpepper, 2011), large financial service firms can be loudly and publicly denied their policy preferences by public authorities. Indeed, the more important the exchange firm is to domestic policymakers, the more likely the firm's preferences on the issue of cross-border integration will be refused. This runs counter to most predictions regarding the nature of financial sector power in an internationalizing economy, in particular work that describes the growing and disproportionate influence of large firms over the cross-border regulatory integration and harmonization decisions made by public officials (cf. Milner, 1988; Rogowski, 1989; Frieden, 1991; Frieden and Rogowski, 1996; Mugge, 2006; Eberle and Lauter, 2011; Pagliari and Young, 2014; Young and Park, 2013; Farrell and Newman, 2014a).

Indeed, a key inference driving this dissertation is that business decisions made by infrastructure firms – for instance around capital allocation, the distribution of market and investment activity, and the responses to downturns and/or crises – have an impact on regulators' capacity to execute various pieces of their agenda. As a result, regulators want to maximize their influence over those business decisions and take steps to ensure that they can shape them on a forward basis, steps which – as the empirical chapter show – may in fact enable subsequent integration. Empowered regulators in a firm position of control are not threatened by cross-border integration, in contrast to dependent regulators. This inference in many ways flips the regulatory capture perspective on its head, in that it suggests close ties between regulators and the firms they regulate may be a source of potential power and capacity for the public side of the equation – and not uniquely a source of disproportionate influence for the private sector (Stigler, 1971). Merger episodes bring the nature and extent of this public influence over private

decision-making into stark relief, and challenge regulators to consider whether that power is threatened, and if so, how to retain or buttress it.

The corollary of this counter-intuitive finding regarding regulators' power to shape firms and markets also contains a fascinating irony: as public officials' influence over domestic financial service firms and the markets they operate in increases (i.e., officials' dependence on those firms to self-regulate and self-police decreases), public officials become more likely to enable international integration involving those firms. As the case studies in this dissertation make clear, more direct public control over market outcomes can even be a predicate for higher levels of international integration involving the financial service firms (Spendzherova, 2014). In that sense, more rules can give way to more integration.

Beyond these counter-intuitive findings, why is the phenomenon of regulator dependence of interest to political scientists?

In considering the power resources of domestic officials, the dissertation sits comfortably within a well-established line of inquiry in international and comparative political economy, particularly a literature that examines the capacity of domestic regulators to forge an independent policy trajectory under conditions of global capital mobility and international market integration (Strange, 1988; Goodman and Pauly, 1993; Garrett, 1994; Mosley, 2003; Rodrik, 2007; Cohen, 2008). Like this scholarship, the dissertation is attuned to questions of public autonomy and power in a global economy that is shaped by private exit options, information asymmetries across the public-private divide, and normative beliefs about the appropriate limits of state action – with possible material sanctions for states and officials that breach convention. At the same time, this dissertation contributes new elements to this research tradition, and adds nuance to some established arguments within it.

This dissertation is particularly focused on the consequences of private sector transactions for the power of regulators overseeing the transacting firms. Regulatory power itself is therefore a centrally important key concept. To date political economists have theorized regulator power in two ways:

- **As a function of some underlying economic conditions.** That is, regulatory power varies with: a jurisdiction's levels of capital controls and exposure to international markets (Goodman and Pauly, 1993; Haggard and Maxfield, 1996; Mosley, 2003); the feasibility of certain policy options, which are defined by the material consequences of previous policy decisions (Helleiner, 1994; Newman and Posner, 2011); or simply market size (Hirschman, 1945; Krasner, 1976; Simmons, 2001; Drezner, 2007);
- **As a function of the availability and effectiveness of various policy tools in the 'regulatory toolkit'** that officials can use to project or buttress their power. Not all tools are equally feasible across issues areas, or time and space, because of their distributional impacts as well as the prevailing ideational framework (Abdelal et al., 2010). That said, many policy strategies are used to augment efforts to effectively oversee private financial flows. To date, scholars have focused on: cross-border harmonization (Singer, 2004, 2007), multilateral cooperation, suasion or persuasion (Simmons and Elkins, 2004; Bach and Newman, 2010), unilateralism (Simmons, 2001), delegation to private firms or international organizations (Buthe and Mattli, 2011), or coordination through public-private policy networks (i.e., embeddedness) (Evans, 1995).

The theory of regulator dependence expands upon these existing treatments of regulatory power in three ways.

First, this dissertation elaborates and builds predictions about the use of a policy tool that is empirically observable but not yet theorized. Interference in the cross-border market for corporate control is not a tool that is generally considered part of the regulatory ‘toolkit’ under conditions of contemporary cross-border financial market integration. It is a rational and predictable response by public authorities to the threat of a reduction in their power over private firms, and as such is a key dynamic in the back-and-forth between public and private entities in an era of global capital flows. More precisely, it represents a strong move by public officials to stand in the way of cross-border integration that threatens their ability to effectively oversee and shape the capital markets they are responsible for managing. But this strategy – what is essentially territorially-based protectionism on the part of capital market authorities – has not yet been a focus for political scientists. Given that the choice to stand in the way of private firms’ cross-border integration efforts in many ways upsets assumptions about the imbalance between private and public power in the global political economy, not recognizing this policy option is a significant gap in political scientists’ understanding of contemporary financial regulation – and a significant addition to our understanding of the regulatory toolkit.

Second, the dissertation endogenizes the choices made by regulators at key inflection points. Proposals for the cross-border integration of major financial infrastructure firms can reasonably be characterized as such decision-points – i.e., policymaking moments that explain the subsequent depth and extent of global capital market integration and private firms’ reach and mobility.

Understanding how open capital markets affect regulators’ capacities requires that political scientists also understand how those markets were built in the first place. Indeed, decisions about cross-border market structure subsequently shape regulators’ power and capacity. In particular,

these decisions establish the extent to which regulatory jurisdictions and private markets overlap – which is important because this overlap dynamic has been convincingly theorized to have significant impacts on the distribution and exercise of regulatory power (Posner, 2009a; Newman and Posner 2011). Observing and explaining variation in officials’ choices at these decision points therefore promises positive analytical gains, and also has clear normative implications for our understanding of the sources and limits of public power vis-à-vis private firms. Unlike existing scholarship, which helpfully elaborates the policy decisions (regarding capital or trade liberalization, or the relaxing of certain foreign ownership restrictions) that have given rise to *capital market integration* across borders, the focus here is on decision-making on *firm-level integration* efforts. Notably, the broad legal and regulatory barriers to cross-border ownership of financial service firms have been loosened, and yet political forces continue to shape the success or failure of proposals to integrate at the firm level across jurisdictions. This is worth unpacking further. Given that capital has mobility and financial services have substantially globalized, what makes some firm-level integration efforts too much for public sector officials to bear? This dissertation begins to answer that question from the perspective of market authorities, with a focus on their power and capacity.

In this way the dissertation follows scholarship that sees existing levels of global capital market integration as a puzzle to unpack rather than an exogenous variable that can explain subsequent political dynamics (Haggard and Maxfield, 1996; Best, 2005; Watson, 2007; Chwioroth, 2007; Chwioroth and Sinclair, 2013). Private and public decision-making about the cross-border integration of private financial services firms gives shape to markets, and this dissertation adds a new dimension to understanding those decision-making processes at important junctures in the integration process.

Third and finally, the dissertation unpacks the role of private firms – and particularly the commercial choices of large financial infrastructure firms – in shaping regulatory power and capacity. At a basic level, the dissertation thus has common ground with now-dated neo-mercantilist scholarship (Gilpin, 1975; Katzenstein, 1976), which viewed multinational corporations as appendages of national (predominantly American) officials who sought to project their free-market preferences abroad, in an apparent Trojan Horse manner. This dissertation, however, does not observe a positive monotonic relationship between firm internationalization and the power of public actors – indeed, it argues that in many circumstances the emergence of a multinational firm may weaken the capacity of domestic regulators to effectively oversee it. To understand when and why this is the case, the dissertation considers the relationship between regulators and the firms they oversee on the basis of historically-rooted institutional allocations of both regulatory and market power.

### **Case selection and methodology**

To test the theory and provide these analytical gains, the dissertation contains three empirical chapters that consider a total of seven merger cases:

- The failed merger between the London Stock Exchange and the Toronto-based TMX Group in 2011, with a shadow examination of the merger between Australia’s ASX and Singapore’s SGX over 2010-2011 that was blocked by the Australian government;
- The history of mergers involving Euronext, including its founding in 2000 (Amsterdam, Brussels, and Paris), its merger in 2007 with the New York Stock Exchange, and the subsequent takeover of NYSE-Euronext by the US-based Intercontinental Exchange in

2013-2014, with a shadow examination of the approved merger between Sweden-based OMX and US-based NASDAQ in 2007-2008.

- The merger between NYSE-Euronext and Germany’s Deutsche boerse in 2011-2012 that was blocked by the European Commission.

Table 3

*Summary of case studies*

<b>Primary cases</b>	<b>Type of regulatory response</b>	<b>Outcome</b>	<b>Blocked by regulator</b>
TMX-LSE	Negative	Failed (interference)	No
NYSE-Euronext	Positive	Approved	Yes
NYSE-Euronext – Deutsche Boerse	Negative	Blocked	Partly
<b>Secondary cases</b>			
ASX-SGX	Negative	Blocked	Yes
Euronext	Positive	Approved	No
ICE- NYSE-Euronext	Positive	Approved (with key conditions)	No
NASDAQ-OMX	Positive	Approved	No

These cases provide variation on several key sets of variables. First and most obviously, there is considerable variation on the dependent variable, i.e., whether the mergers are blocked or allowed, as the cases include blocked, informally interfered-with, and approved mergers. Two cases featuring official vetoes are examined (in Europe and Australia), as well as an example of behind-the-scenes interference leading to commercial failure (Canada). These are counterpoised against four distinct mergers that received approval, three of which were transatlantic in nature.

Moreover, within groupings of approved or failed cases there is interesting variation in the types of conditions imposed by authorities, variation that provides additional tests of the logic of the theory.

Second, the cases are selected in order to subject the theory to different *types* of tests. In the Canadian and Australian cases the mergers are considered as one-off episodes and the level of regulator dependence is tested on a static basis. The chapter on Euronext subsequently considers the effects on mergers as the exogenous level of dependence changes over time, a dynamic test that is applied against three mergers. Finally, the chapter on the DB-NYSE-Euronext merger subjects the theory to hard tests, not least of which is that the deal was not blocked by a market regulator, but by a competition authority.

Third, the case selection controls for the potential impact of the financial crisis on regulators' decision-making, by considering mergers before the crisis as well as both blocked and successful cases after the crisis. The general observation of successful and blocked mergers on both sides of the crisis suggests that it is not an efficient explanation of the outcomes observed.

Finally, the types of jurisdictions involved span many of the typologies contained within the VOC and related approaches. Mergers involving liberal states as well as *dirigiste* systems are considered. As described above, institutionalist explanations that differentiate by domestic regime types do not appear able to account for the observed outcomes, and the case selection allows for that to be demonstrated. That said, the case involving a coordinated market economy (CME) – i.e., the Deutsche Boerse proposal to merge with NYSE-Euronext – is not investigated at the national level in this dissertation, but is instead analyzed as a “hard test” of the theory at the level of European Union institutions. Furthermore, there are no cases involving Japan or

indeed other Asian jurisdictions, where the applicability of the VOC approach has been increasingly tested and scrutinized in recent scholarship. This presents potential limitations on the boundaries of the theory, i.e., its external validity beyond the cases and types of economies contained in the dissertation. The impact is discussed briefly in the concluding chapter, in the discussion on the theory's external validity.

The dissertation deploys a qualitative methodology to test its theoretical claims. In order to do so effectively, four distinct sets of expected observations of the theory are identified – two of them presenting scope conditions, two of them presenting hypotheses – and the types of tests that each presents to the theory are considered. The empirical chapters subject the theory to tests on the basis of those observable implications through the use of a triangulation strategy that considers primary source material, secondary journalistic and academic analysis, and confidential interview data combed from interviews with more than 50 individuals involved in the mergers. These interviews took place in seven jurisdictions between 2012 and 2014. This strategy is used to process-trace the outcomes in each of the mergers to establish whether not only the outcomes, but the underlying causal processes match the expectations of the theory at a detailed empirical level.

The choice of a process tracing methodology is appropriate for small-n research efforts such as this one, because it enables the testing of causal claims that might otherwise be confounded by the absence of observed outcomes across a large number of cases. This is because process tracing considers not only whether predicted values on the dependent variable align with the expectations of the theory, but also whether those predicted values emerged through the causal mechanisms and transmission channels embedded within the theory itself – and indeed, this methodology can even demonstrate the partial validity of the theory in cases

where observed outcomes do not entirely align with their predicted values. The use of process tracing to test a theory draws leverage from within-case observations of predicted empirical phenomena rather than just cross-case variation of outcomes. In short, process tracing allows researchers to demonstrate that events unfolded the way a theory predicts they would – not just that outcomes took some predicted ultimate shape.

This dissertation’s theoretical explanation for merger outcomes relies on a single independent variable – regulator dependence – and it is therefore not inferentially problematic to only test the theory against observations in a small number of cases, as long as those cases demonstrate significant variation in the level of regulator dependence (which they do). The impact – or indeed, the provenance – of different types of regulator dependence are neither theorized nor tested in this dissertation. What is more, the dissertation is not set up to as a test of different theoretical explanations by assessing co-variation across cases. In this way, the number of cases ought to be sufficient to provide leverage for the causal claim that regulator dependence shapes merger outcomes.

However, even where multiple possible causal mechanisms are being assessed – i.e., across different theories or within a single theoretical apparatus with multiple independent variables – as to their causal impact on observed outcomes, process tracing would still enable researchers to differentiate between the causal effect of those different potential explanations and draw leverage from empirical process observations. Furthermore, where the number of theories competing for leverage and/or variables theorized to have causal impacts outnumber the number of cases, process tracing can usefully mitigate the challenges relating to a “degrees of freedom” problem – i.e., the concern that it is not possible to identify and measure the causal impact of each independent explanation or variable because the cases cannot (numerically) feature

sufficient variation on each one, leading to confounded causal claims. Process tracing can show independent variables – and related causal mechanisms – at work even in the absence of sufficient degrees of freedom. In this sense, the use of a process tracing methodology allows for confidence that a more complex chain of causal claims than the one presented in this dissertation has empirical validity. For a theory with just a single independent variable (like the theory of regulator dependence), the confidence-enhancing impact of process tracing is equally strong, if not necessarily stronger.

### **Plan of the dissertation**

The next chapter elaborates the financial exchange industry from a political economy perspective, providing the needed context as well as background to familiarize the reader with important terms, concepts, and dynamics. In addition, it considers the limited literature on the exchange industry in political science to date to highlight many of the key political considerations that are relevant for the empirical analysis that follows.

The subsequent, third chapter develops the concept of “regulatory power” in more detail. It assesses the treatment of regulatory power in the literature and draws out important inferences and implications upon which the theory is subsequently grounded. The chapter then assesses in detail existing political explanations for integration decisions in global finance. It notes how these explanations cannot account for scenarios in which insulated market officials make decisions on the basis of their autonomous preferences, which opens the way for an alternative theoretical approach to such scenarios.

Chapter four presents the theory of regulator dependence, considering first the interaction between corporations’ multinational business activities for regulators’ power and autonomy,

before proceeding through the assumptions and mechanisms of the theory, and detailing the observable implications that follow.

Chapters five through seven present the empirical case studies. They process-trace decisions in seven merger episodes since 2007 to establish the degree to which the observable evidence corroborates or adds nuance to the expectations of the theory.

Finally, the dissertation concludes by considering its findings, and presenting some additional research questions that may frame future efforts regarding the regulatory politics of cross-border integration in finance (and beyond).

## **CHAPTER II**

### **THE POLITICS OF FINANCIAL EXCHANGES**

#### **Introduction**

Why are exchanges merging, and how is the exchange industry politically salient? In the last decade the stock exchange industry has undergone significant changes. Exchanges have become for-profit firms with widely-held shares, a change which complicates their status as utilities and as self-regulating organizations. The emergence of algorithmic high-frequency trading has increased the prevalence of arbitrage activities on exchanges at the possible expense of uses for end-users, including price discovery and capital formation. Many exchanges are vertically integrated to offer post-trading services such as clearing and settlement, as well as data provision and IT infrastructure: this has further extended their business interests into for-profit financial services. And as deregulation has lowered the barriers to entry in the exchange industry, incumbent firms have lost market-share to low-cost electronic upstarts. Cross border integration has been one of the ways in which exchange firms have sought economies of scale and synergies to respond to their declining revenues and market share.

This chapter first grounds the phenomenon of exchange M&A in an overview of the exchange industry – focusing on the key institutions, the regulatory environment, market structure, and the drivers of exchange M&A. It then moves on to consider the political implications of capital market activity generally, and looks at existing political science scholarship of relevance to the exchange industry.

## **What are exchanges? A primer on market infrastructure**

There are two basic types of exchange infrastructure that are relevant for this dissertation: trading and post-trading facilities. Within each of these categories there are several types of institutions.

Trading venues – or markets – include both stock and derivative exchanges. Stock exchanges (such as NYSE, the Toronto Stock Exchange, or the London Stock Exchange) bring together buyers and sellers of equities, or stocks in a listed company, but such markets may also offer corporate debt products as well as some equity-based derivative products, such as options or index-based products. Stock exchanges retain primary responsibility for offering a listing service for firms to make a public offering, and also maintain the primary market infrastructure and trading venue for those firms – including trading technology as well information and data services that help communicate the company’s financial fundamentals to investors. As such stock exchanges often have certain regulatory responsibilities, particularly for listing standards (including disclosure, capital, and transparency rules), trading and execution standards, and monitoring obligations.

Derivative exchanges (like Eurex, the Chicago Mercantile Exchange, the Montreal Bourse, or the London International Financial Futures and Options Exchange, now called ICE Futures Europe) similarly bring together buyers and sellers of a financial instrument. Rather than trading in equities (i.e., an equity position in a public company), derivative exchanges offer contracts such as futures and options, which establish some type of commitment or position – for instance to buy or sell, or an option to buy or sell, or to pay a counterparty a variable amount of money – based on the future valuation of an underlying good (such as foreign currency, cattle, oil, cash, etc.) or benchmark price. Buyers and sellers of a contract take on obligations to one

another based on their desire to manage their exposure to some underlying commodity, rate, or benchmark – enabling them to hedge against foreseeable risks they face as producers and consumers, as investors, or as money managers.. Exchange users go through intermediaries to trade in contracts relating to wheat prices, interest rates, corporate or sovereign defaults, and other underlying values. These contracts come with standardized terms and references that are pre-packaged and offered by the derivatives exchange firm. Many users, like hedge funds, frequently use the contracts for speculative purposes. Often, the two counterparties to a derivatives contract will be making opposing bets on the future price movement of the underlying product, whether it is because they have access to different data, are hedging different risks, or have unequal financing capacity for positions they would like to take. Importantly, the exchange-traded derivative contracts they enter into are developed and owned by the exchange itself, quite unlike an equity, the latter of which is the property first of the firm and then the buyer of the stock. As such, a particular exchange-traded derivative contract can only be offered under license from that exchange. For instance, a Eurobond future traded on the Eurex exchange in Germany is a proprietary contract that can only be bought or sold on Eurex (or a venue licensed by Eurex).

New regulations and changes in the market across many industrialized economies have encouraged a third type of electronic trading venue, like Alternative Trading Systems in the US or Multilateral Trading Facilities in Europe. While stock and derivative exchanges also run fully-automated trading systems, the electronic exchanges are different in that they often have lower regulatory and compliance burdens, and can offer matching services for products that are listed and maintained elsewhere. A NYSE-listed blue-chip trade can be executed on an alternative electronic venue – and in fact is more often than not traded on an exchange other than

the NYSE. This competition has had profound effects on the equities trading industry (see below); this is not yet true of the derivatives market, where electronic trading is limited by the proprietary nature of exchange-traded derivative contracts, making it very difficult to break the monopoly on trading of any particular contract. That said, off-venue electronic trading in derivatives takes place, as over-the-counter (OTC) derivatives are sold by dealer banks to clients, and are often frequently matched on electronic venues operated by banks or broker-dealers – some of which are large and profitable companies. Post-crisis reforms are mandating that the execution of many OTC derivatives trades takes place on new and more transparent exchanges, called Swap Execution Facilities in the US or Organised Trading Facilities in the EU.

The second major type of trading infrastructure is post-trading: clearing, settlement, and payment facilities. Settlement and payment systems for exchanges are beyond the purview of this dissertation, and are linked into the broader payment system in place in a jurisdiction (i.e., for bank transfers, and debit and credit card systems). They ensure that accounts are settled between financial institutions, at some regular interval. In the trading industry, the settlement system ensures that the buyers and sellers of a security receive/pay accordingly.

More important to this dissertation is the clearing function, particularly as it is executed through central counterparties or CCPs. A CCP stands between the counterparties to a contract and “clears” it by becoming both the buyer and the seller of that contract and/or security. While technically complex, at root CCPs serve to minimize *counterparty risk* – that is, the risk that one party to a bilateral transaction will default before the transaction is completed or, in the case of derivatives, the contract matures and comes due, thereby leaving the other party to absorb the loss. Given the multiyear maturity of many derivative contracts, as well as the complex web of outstanding counterparty obligations at any given time, the counterparty risk in derivative

markets is particularly high, and the *risk of contagion* is also very high. CCPs concentrate and minimize those counterparty risks; they have in place financial resources and protocols that can be used to offset exposures in the event of a large counterparty default. These tools were, for instance, used to great effect in the orderly winding-down of Lehman Brothers' outstanding positions, ensuring that the various counterparty losses were minimized and the knock-on impact on its trading partners was not so extensive that it generated additional insolvencies.

CCPs are often vertically-integrated into exchange firms, meaning that counterparties to a contract can trade that contract and clear it within the same firm – for instance, major exchange firms like Eurex and CME both offer clearing services as well as trading venues for their derivative contracts (although this ‘vertical silo’ model is currently the subject of review and change, particularly in Europe). As a result, CCPs may generate efficiencies, enabling trading counterparties to net their obligations and rationalize their collateral requirements. This system has the ancillary benefit of giving prudential regulators a look-through at the positions and exposures of key firms – and it may contain systemic risk to single CCPs rather than spreading it across a network of interlinked clearing houses. Indeed, CCPs have gained prominence in the post-crisis period as a means to both increase transparency and lower risk to OTC market participants, as well as taxpayers.

### **The regulation of market infrastructure**

The regulation of stock markets is complex and multifaceted – not least because it has been the site of substantial change in the past two decades. Among the most important of these changes are the following:

- exchanges have received approval to demutualize;

- regulatory agencies have taken a relatively standardized form and become arms-length, depoliticized bodies across most developed markets;
- regulators have introduced competition into the exchange marketplace, particularly for equities;
- the breadth of exchanges' self-regulatory capacities and responsibilities has shrunk;
- and a host of multilateral organizations and MOUs have been developed to coordinate an increasingly-globalized exchange marketplace.

Despite the complexity wrought by these changes, exchange regulation in general can be distilled down to a few key elements. As will be made evident in later chapters of this dissertation, each of these elements comes into play during mergers and acquisitions.

The first is investor protection. In order to ensure that markets are efficient and liquid it is paramount that regulators minimize fraudulent or unfair trading practices – otherwise, investors will be wary of committing their resources to equities markets, and the capital-raising activity of firms will become costlier. Similarly, fraudulent activities on derivatives exchanges can hurt investors who use those exchanges to hedge against various exposures, for instance group investment plans such as mutual and pension funds. Furthermore, regulators have a strong incentive to minimize cases of investor fraud because such cases tend to attract the attention of their political bosses, for whom letters and phone calls from defrauded households are an unwanted source of political aggravation. As a result, regulators of equities markets take steps to ensure that publicly-traded companies are as transparent about their financial resources and fiscal position as is possible. Regulatory standards impose strict disclosure and auditing requirements to ensure that listed firms are of a certain calibre – enabling investors to make informed decisions about the value and prospects of those firms.

In the US, many of these rules have become even more extensive in the post-Enron era, as the Sarbanes Oxley corporate governance reforms reached well into the business firm to mandate certain accountability and auditing procedures for public firms. This compliance burden is costly for firms, but it often has the corollary effect of minimizing the various premia they must pay investors; indeed, studies have shown that firms listing in the US, and therefore complying with SEC rules that are considered more onerous than their global counterparts, pay less for their capital than do overseas firms facing laxer standards – particularly smaller firms historically considered to have looser internal controls (Stephen and de Jong, 2012). Many of these regulatory requirements have historically been the purview of the exchanges themselves, but since demutualization public concern about exchanges’ skewed incentives – i.e., to gain listings rather than vet prospective firms carefully – has led to either a re-nationalization of those powers, or their delegation to private self-regulatory bodies that are funded but not controlled by the exchanges, including the Financial Industry Regulatory Authority (FINRA) in the US and the Investment Industry Regulatory Organization of Canada (IIROC).

This is tightly bound up with a second regulatory priority, which is ensuring market integrity. The words “market integrity” are actually built into the mandates of many key regulators, including the SEC in the US, and the Ontario Securities Commission. This part of the regulatory mandate has several components, but perhaps the most central ones are the trading and execution rules. Access to trading is the first pillar – who may offer and execute trades? In many countries access is determined by professional qualifications and association membership, as well as jurisdiction and location (i.e., to ensure regulators’ access in the event of malfeasance). Traders, brokers and advisors are heavily regulated and self-regulated actors, and while lapses are frequent they are nominally held to high ethical and professional standards. The second

pillar is trading execution rules, particularly the manner in which brokers must execute on behalf of their clients. These rules as they relate to equities markets have been radically altered in recent years, and now brokers must provide what is called ‘best execution’ for their clients. This is part of a broader effort to force competition into the marketplace. Best execution may either be by stock price (in the US) or some other set of calculations (in the EU, where ‘best execution’ may be based on the provision of anonymity, price, and services demanded by the client) (Gadinis, 2008a). A third component relates to strict rules around insider trading, designed to ensure that market outcomes are fairly balanced between insiders and outsiders – again, crucial for ensuring that investors have faith in the market as a place to generate returns on investment, and therefore ensuring that markets are liquid and efficient. This has the additional benefit of maintaining the efficiency of the pricing mechanism – where trades are executed frequently and by a large group of informed participants, the quality and rationality of stock pricing is theorized to increase and the utility of the market as a mechanism for pricing equities and assets increases in kind. This, of course, is subject to large caveats relating to investor exuberance and irrational herd behaviour, beyond the purview of this discussion.

The third priority relates to market structure. The introduction of competition into the exchange marketplace is discussed below, but the crucial concerns for regulators here are twofold: the pricing mechanism and cost structure. In fact, there may be a trade-off between these two agenda items. Introducing competition into the exchange market, like in most sectors, has the effect of introducing downward pricing pressure on the exchanges, and results in lower trading and listing fees as well as cheaper ancillary services. Competition is therefore a lobbying victory for exchange clients (namely banks and other brokers) rather than the exchanges. However, regulators need to balance those efficiency gains against the costs of splitting liquidity

across multiple venues. Fragmented liquidity, as it is often called, may result in a reduction in the quality of pricing, as trades are executed across venues and that information does not immediately scale up to a single pricing output.

Fourth, many regulators are interested in the employment and market competitiveness impacts of exchange governance. That is, they pursue not only a market-quality mandate but also an industrial policy mandate. In jurisdictions where this is the case, it is likely to be an informal consideration (in fact, it is likely to be an informal consideration in nearly every jurisdiction, not least because market regulators are generally accountable to politicians who care deeply about such things). As a result, regulators will at least implicitly balance the gains of stricter regulation in terms of market integrity against the potential losses resulting from stricter requirements, leading to potential exit by firms engaging in regulatory arbitrage (Singer, 2004). Such exit not only hurts regulators from an industrial policy perspective, but also reduces their power, by reducing the number of real market transactions being executed in the jurisdiction.

Fifth, regulators often consider systemic risk effects and implications related to the management and use of exchange infrastructure firms. This has been increasingly salient since the financial crisis, which many authorities at least partly ascribed to the use of complex financial instruments called credit default swaps (CDS), a type of OTC derivative that is traded on a bilateral, off-exchange basis, and was implicated in market participants' uncertainty about their exposures, losses, and overall cash positions as key counterparties – namely Lehman Brothers – went bankrupt. In 2009, the G20's 'Pittsburgh declaration' compelled member states to fundamentally re-regulate these over-the-counter derivative markets, mandating in particular that certain OTC derivatives be traded on exchange-like platforms, reported to authorities, and centrally cleared to reduce the risk and impact of a counterparty default like Lehman's (G20,

2009). The technical details of this agenda and its implementation remain unsettled in many key jurisdictions, but exchange firms have an increased role to play in bringing transparency and stability to derivative markets and providing the infrastructure that regulators needed in their efforts to do so.

Finally, regulators are increasingly dealing with issues relating to the internationalization of capital markets – particularly the need to address the mobility of both exchanges and their clients. First, cross-border market activity involves the extensive use of MOUs between regulatory authorities in order to share resources (particularly relating to the tracking and punishment of fraudulent activity). It also involves key decision-points for authorities determining when to allow foreign brokers and dealers access to the domestic marketplace. Because firms seeking access to a foreign market may find it difficult to comply with both their home regulations as well as the requirements of the foreign regulator – in many cases, they are unable to comply with both rulesets if they are not identical – authorities have experimented with varying degrees of mutual recognition or “substituted compliance” (Tafara and Peterson, 2007). Under such a regime, a firm may operate in a foreign market while only complying with its domestic rules. At present, many exchanges and exchange clients make use of such permissions, particularly in Europe but also in the derivatives exchange sector, as – for example – the US Commodity Futures Trading Commission (CFTC) has licensed many foreign venues and brokers to operate in the US under their home rules only. This is a means of ensuring that cross-border market operations are held to a standard that two sets of authorities agree is equivalently strict and effective, while also ensuring that the compliance burden on private actors does not unnecessarily impede the efficiency gains of cross-border capital market activity (Nicolaidis and Shaffer, 2005).

It is important to flag that these priorities are not equally salient across jurisdictions. For instance, it has traditionally been the case that the SEC has been more rigorous on investor protection than its European counterparts. This is because US capital markets have more retail investor users – that is, small scale, household-based investors without the resources or capacity for in-depth research and analysis. These investors require greater protection, in theory, than institutional investors’ including investment plans, pension and fund managers, banks and proprietary trading firms – actors who have traditionally dominated Europe’s capital markets.

Similarly, responsibility for market regulation is not necessarily divided in an even or standardized way across jurisdictions. For instance, in most countries derivatives and equities regulation is undertaken by a single regulator. In the US, the SEC handles equities (and derivatives based on ‘single name’ equities) and the CFTC is responsible for derivative markets. They report to different Congressional committees. Furthermore, the Federal Reserve and Treasury also have stakes in systemic infrastructure like CCPs. This leads to turf wars and political challenges, as well as logistical and cultural difficulties across the institutions. Canadian markets are regulated at the provincial level, leading to difficulty in both domestic and international coordination exercises (although this is changing, as increasingly Canadian regulators are speaking with a single voice and even coordinating their efforts). In Europe, the challenge in market regulation is similar to that in other issue areas, as the multi-level process of building a single market with single rulebooks is a slow and politically complicated process. Each of these parochial differences is highlighted and explained where necessary, in the empirical chapters.

This overview of the regulatory landscape has necessarily left out many key issues and dynamics, but it serves as a contextual effort for the theoretical and empirical work that follows.

However, two of these regulatory developments are worth exploring in a bit more detail, as they are central drivers of M&A.

### **Demutualization: the move from member owned exchanges**

Beginning in the mid-1990s most exchanges demutualized. Prior to this change, exchanges were owned and managed by their principal users, who controlled access to and the benefits of the exchange. Those owners, largely large brokerages and securities dealers (like banks), increasingly saw benefit to demutualization as capital markets became more globalized and frictionless. These changing interests and incentives on the part of exchanges' financial firm owner-membership – particularly to lower trading, regulatory, and management costs – pointed to a commercially-focused, publicly-traded firm model, which among other things was seen to enable innovation, efficiency, and liberalization in the exchange industry (The Economist, 2005; Aggarwal and Dahiya, 2006; Fleckner, 2006; Ramos, 2010). Exchanges thus moved to a different and more explicitly commercial structure so that they could more effectively raise capital and execute innovative business strategies that would keep up with both the shifting demands of their users and the changing, more competitive market structure brought in by new regulations.

### **Competition and deregulation**

The exchange industry has seen a significant increase in competition in the last ten to fifteen years. On a typical trading day in jurisdictions across North America and Europe, volumes (both overall, and for any given equity) are split between the big incumbent exchanges and upstart electronic venues. This is the result of regulations in the US (Regulation NMS) and

the EU (MiFID) that have encouraged competition in the exchange industry by licensing alternative venues, and then mandating their use by requiring that brokers offer their customers best execution – which will frequently mean that they must execute on one of the non-incumbent exchanges.

As exchange users have pushed for ever more competition in the industry, and regulators have provided it, exchanges have subsequently had to respond to increasing competition from upstart electronic trading systems (including Alternative Trading Systems /ATS or Electronic Communication Systems /ECN). These so-called ‘dark pools’ of liquidity operate as off-exchange matching engines, frequently operated by large investment banks, with lower transparency requirements – particularly around pre-trade pricing (Chesini, 2010). These low-cost alternatives offer buy-side firms an alternative venue for trading exchange-listed equities as well as derivative products, and debt instruments like bonds. Because they do not have the administrative and enforcement burdens facing the incumbent and self-regulated exchanges they can pass along those cost savings to their users, sometimes even offering exceptional rebates to high-volume “liquidity makers” who are essentially compensated for executing trades (Pan, 2007; Chesini, 2010). They can also provide trading anonymity so that investors can make large-scale moves in or out of a particular position without algorithmic trading systems picking up on that movement and moving prices by ‘front-running’ the initial investor.

This has translated into two trends: the incumbent exchanges have experienced a shrinking share of trading volume in their listed equities, and listing fees have been shrinking as an overall source of revenue for those exchanges (Lee, 2010, pp. 35-37). Incumbent exchanges have responded to these regulatory changes by becoming for-profit firms, which has allowed them to more effectively raise capital to continue to upgrade their technological capacity, as well

as diversify their product and service ranges. For example, many exchanges have entered the ATS business by buying upstart competitors (The Economist, 2005); others, like NASDAQ-OMX, have become leaders in developing and selling off-the-shelf trading technology to exchanges around the world.

Because of the particular economic features of derivatives contracts – particularly their proprietary nature, but also the margining efficiencies that are generated by trading and then clearing on single venues – it has proven much more difficult to encourage competition in this industry. Post-crisis regulatory reforms have aimed at introducing new venues for OTC derivatives (SEFs in the US and OTFs in the EU), and have introduced some levels of vertical-silo busting ‘open access’ policies. Still, competition in the world of futures is limited – as evidenced by the DB-NYSE-Euronext merger case.

### **Understanding cross-border mergers and acquisitions in the exchange industry**

Exchange firms have engaged in cross-border M&A as a response to these market and regulatory pressures, which are coming from both the demand and supply side. On the demand side, exchange operators must meet the consumer preferences of mobile and discriminating users – both investors and listing firms – meaning that they must offer a broad suite of services, including data services and high-performance technology, in order to stay competitive. Prospective clients can and do select trading venues for their technological advantages (like low “latency” or execution time, and co-location for high-frequency algorithmic traders), the availability of margining efficiencies through vertically-integrated in-house clearing and settlement infrastructure, or the regulatory environment in which an exchange is located.

On the supply side, exchange clients have increasing numbers of options. First, there are increasing numbers of liquid markets globally where prospective exchange clients can do business. The US and UK no longer hold an effective monopoly over deep, liquid, secure, and attractive capital markets (Brummer, 2012, pp. 49-51). And second, as mentioned, there are increasing numbers of alternative and electronic exchange venues populating those capital markets. Incumbent markets, like the US and UK, and the large and nationally-dominant incumbent exchange firms, like NYSE, TMX, or the LSE, are facing a new world of competition both within and beyond their borders. Regulation has contributed to this supply-side pressure, by creating competition that often favours the exchanges' users over the incumbent infrastructure firms.

Cross-border mergers are a partial solution to these combined demand and supply side pressures in that they may help exchange firms realize both economies of scale and economies of scope. Economies of scale can be in the form of revenue synergies: as the exchange industry is both high-fixed cost and volume driven, a bigger firm can decrease the relative per-unit costs of maintaining trading infrastructure, upgrading technological systems, or subsidizing its enforcement, service-provision, and administrative systems. Potential synergies in trading technology and infrastructure are frequently cited as part of merger proposals, and merged exchanges have downsized their operations through staff layoffs, making the 'backroom' case for merging (Enderlein, 2011, pp. 48-9). Moreover, the best merger candidate for a particular exchange to realize these synergies is frequently an overseas exchange – either despite or because of regulatory differences across jurisdictions (Miller and Pagano, 2007; cf. Lees, 2011).

Mergers also generate economies of scope by allowing incumbent exchanges to diversify into new product ranges without investing in their development. This is especially important

because trading in equities now represents less than half of total revenues for many exchange firms, and mergers may allow a firm to diversify into technology and systems development, trading of particular proprietary derivative products, post-trading clearing and settlement, and other products (Lee, 2010, pp. 35-37). This is particularly the case if an exchange in one jurisdiction is prohibited by regulations or market forces from entering into a particular market activity, an impediment it can get around by buying a firm with operations in that segment in another jurisdiction. More broadly, regulatory differences and market forces across jurisdictions can lead to revenue opportunities in one jurisdiction that are unavailable in another (Valiante, 2011, p. 2).

In sum, cross-border mergers can help exchanges cut costs while boosting their revenues from diverse sources. In contributing to the firms' bottom line, and helping them realize shareholder value as public companies, global industry consolidation is a logical response to a competitive market environment. But regulators are not agnostic about the impacts of these market transactions on their ability to promote particular public goals in the sector. The next chapter offers a theory that explains the varying responses to cross-border proposals involving these infrastructure firms. Before that theory is introduced, this chapter concludes by considering the many political implications of this exchange activity, in order to ground both the theory and exchange consolidation in a broader political-economic context.

### **The political economy of the exchange industry**

Why are exchanges of relevance to political scientists? What is the political impact of exchange governance and capital market regulation?

At a broad level, the political implications of various forms of capital market activity have been investigated in political science, particularly the distributional impacts of different financial systems and market policies.

Well-established institutional accounts (Zysman, 1983; Hall 1986) have noted the centrality of credit creation and capital allocation within processes of industrial coordination and production. How capital is allocated – to whom and by which actors, with what incentives – will shape winners and losers as production strategies and levels of global integration change (Frieden, 1991; Keohane and Milner, 1996). The ability to adjust to new incentive and opportunity structures will be a partial function of what kind of capital is available and on what terms.

These differences across national systems of finance are also a key component of the Varieties of Capitalism (VOC) literature. VOC scholars note that the types of economic activity incentivized by different systems of corporate finance have resulted in both different production profiles as well as differently-distributed benefits of those activities. Capitalist systems share profits and generate opportunity across the labour force differently, with greater or lesser degrees of inclusion and exclusion, in ways that are tightly bound up with the financing mechanisms institutionalized in the political economy, along with complementary systems of training, collective bargaining, corporate governance, and others (Hall and Soskice, 2001).

Studies of cross-national variations in corporate governance rules have also noted the political causes and distributional consequences of rules relating to management structures, reporting standards, and mechanisms for holding corporate managers to account – rules that are often tightly bound up with listing and disclosure rules policed by stock exchanges (Gourevitch and Shinn, 2005, Cioffi and Hopner, 2005, Cioffi, 2010). For instance, Gourevitch and Shinn

(2005) test how the preferences of managers, owners, and labour across different systems of capitalism result in different mixtures of minority shareholder protections, transparency and disclosure requirements, and takeover rules – and how changing preferences lead to changing outcomes, for instance as labour groups increasingly hold securities through their mutual fund and pension portfolios. Interestingly, the entry of new groups into capital markets has the potential to upset traditional left-right divisions and coalitions within a dimension of financial policy, such as the proper role of the state in regulating corporate governance; the development of the rigorous Sarbanes-Oxley rules in the US is an example of these complex coalition politics in action (Cioffi, 2006, 2010).

These contributions note that the governance of capital market flows and actors is distributional, in that it establishes privileged insiders as well as outsiders, and can allocate risk and opportunity differently. It clearly matters how transactions and the firms that take part in them are financed and governed, because the impacts of these rules are felt across the political economy, at elite corporate levels as well as within the household (Seabrooke, 2006). As such, the interaction between the regulation of high finance and the material preferences of the median voter is a dynamic with consequences for both policy outcomes and social distribution (Rosenbluth and Schaap, 2003; Clift and Woll, 2012; Kleibl, 2013). Indeed, and as Mugge has recently argued (2013), the nomenclature of "financial services" occludes the fact that financial service firms are not like garbage collectors, hairstylists, or telecommunications service providers. They do not merely provide services in response to demand, but shape lifestyle opportunities, access to capital and social mobility for many members of society - they shape demand itself. Who lends credit, and to whom they lend it; how corporations are managed and in whose interests; and what public policy goals are addressed or impeded by the investment

activities of institutional investors and mutual funds – these are questions of obvious political significance. This significance is at both a causal level (why do these outcomes vary?) as well as a normative and distributional level (what kinds of social outcomes are desirable, and what role do financial systems play in shaping those outcomes?).

In general, then, financial services firms’ activities reverberate beyond their own sector – gains and losses are not contained to the financial sphere but generate externalities, both positive and negative, that have broader social implications. This is true of many industries, particularly heavily regulated ones (in this sense, regulation is endogenous). In finance, regulation may have its most direct impacts on firms’ business activities, but it is clearly not the case that regulation is only aimed at redistribution along the Pareto frontier, affecting the gains and losses of participants in the financial service economy alone. It also gives shape to the distribution of capital and risk across the economy, with more or less Pareto optimizing effects. Crucially, these causes and consequences of financial regulation are not only of interest when regulation has a high level of political salience, for instance in a post-crisis period (Blyth, 2002; Pagliari, 2013). The regulation of capital markets need not be an election issue to have impacts on the household, and in fact appears only to gain that level of broad public salience in exceptional periods. Regulatory decisions are frequently influenced and shaped by ‘quiet politics’ (Culpepper, 2011); that is, lobbying, and coalition and consensus-building through informal processes occluded from public view. At the same time, these ‘backroom’ politics remain interesting because a) they, too, have social effects beyond the parties involved in those processes, making preferences and outcomes important to understand; and b) even within the financial service industry, preferences and incentives are often quite disparate and it is not always *ex ante* obvious who wants what, and which sectors or firms will get what they want (Mugge, 2010). In short,

relatively quiet politics – which characterizes much of the subject matter of this dissertation – are as analytically interesting and normatively significant as regulations that are publicly developed and aimed at the median voter.

This discussion leads to an inference that is at the heart of this dissertation: the business strategies and actions of private firms are a critical determinant of the realization of public policy goals in capital markets. This is perhaps obvious, inasmuch as private compliance with public rules clearly determines regulatory outcomes as much as the content of those rules. However, the significance of this claim is worth stressing. Financial services firms are quite powerful in terms of their ability to shape the financial fortunes of individuals and households, as well as businesses and other market participants. As such, the public sector’s ability to realize some ‘social purpose’ through financial markets means that regulators need private firms to do – or not do – certain things. What is meant by ‘social purpose’ is the set of broader societal outcomes, including but not limited to distributional goals and the provision of public goods, that are desired by public officials.

For instance, in banking, regulators have preferences about access to credit, to mortgages, or bank accounts to promote some desired level of savings and/or investment; in corporate governance, officials push for some set of rules governing class-action litigation, or articulate the rights of insiders and outsiders in hostile takeover efforts because of the impact on employees and shareholders; in the investment community, some politicians or regulators may require publicly-backed institutional investors (such as pension funds) to prioritize domestic investment *qua* industrial policy.

The politics of some of these financial sectors and transactions have been more closely studied than others in the IPE and CPE literatures to date, including the regulation of the banking

and insurance industries; the distributional impacts of trade and the endogeneity of tariffs; the determinants and benefits of foreign investment, and the link to regimes and rules; and the connections between international financial institutions like the World Bank and IMF and private financial service firms – and the implications for development. However, the oversight and actions of financial infrastructure firms has not been in focus to date.

What kinds of social outcomes are these firms implicated in contributing to? There are at least five:

- Exchanges partner in the provision of efficient and transparent marketplaces for savers to turn present-day capital into future returns, and for firms to turn future profits into present-day capital. Exchanges match investors with capital today with firms who hope to create capital tomorrow. In doing so they facilitate economic growth by giving innovative and well-managed firms access to much-needed capital, and contribute to household savings activities.
- Exchanges can specialize and thus target this activity at different categories of firms: this could include upstart or small-and-medium-sized enterprises (SMEs), technology or resource firms that require bespoke regulatory arrangements to promote liquidity (because of their risk profiles), etc. In doing so, exchanges can help distribute capital-raising opportunities across a broad spectrum of the economy, which may generate opportunity and growth in different sectors and geographic regions, and contribute to a public good by facilitating growth.
- By deploying stringent listing, disclosure, and trading rules (among others) as part of their self-regulatory activities, exchanges can increase the transparency of traded firms to investors and augment the overall quality of publicly-traded firms – and markets more

generally. This promotes the integrity of capital markets, which is a key part of most capital-market regulators' mandates. Where retail investors' investments are significant portions of the domestic system of social security, this self-regulating and quality-controlling capacity can also contribute to the stability of market-based welfare state arrangements.

- Exchanges anchor a dense ecosystem of financial and ancillary service firms, and can therefore provide jobs and encourage the stability and growth of a geographically-fixed financial service cluster. While exchanges are not major employers, the jobs that develop around an exchange, including registered traders and brokers, lawyers, accountants, IT professionals, etc. – are good-quality professional jobs that policymakers want to attract.
- Finally – and particularly true for post-trading facilities like CCPs – exchange firms can be market-side partners for public authorities for the management of systemic risk. They do so in terms of data collection and provision, giving what is sometimes called a 'clear look-through' on the outstanding positions and obligations of any one financial service firm at any given time, and so can help regulators to locate hot-button risks. CCPs are also able to give shape to default management processes in a crisis. This lessens the need for a public lender-of-last resort backup for a too-big-to-fail firm by ensuring that any single firm's counterparty obligations, in the event of a default, are managed in a way that enable liquidity and credit to continue to flow through the economy. This lessens risk to taxpayers, lowers the regulatory oversight burden, and contributes to market stability and confidence in both good times and bad.

This indicates that there are several ways in which exchange firms' commercial undertakings can contribute to or work against public officials' pursuit of various social goals. As is true in

many areas of finance, the exchange industry is tied up in the delivery of public policy outcomes – outcomes that have more substantial distributional and political implications than may initially seem obvious. Exchanges are worthy of investigation by political scientists, and deserve greater understanding and focus than has been the case to date.

That being said, financial exchanges have not been entirely overlooked by political scientists, as both exchanges and securities regulation have featured in a small number of interesting studies over the last two decades.

These studies have typically focused on one of two things: first, changes in the delivery and content of securities regulation, at both the domestic and global levels; and second, the role of financial exchanges themselves within broader processes of change in domestic institutions and systems of capitalism. Each of these lines of argumentation helpfully contributes to this dissertation, although each is also in need of being expanding upon.

On the delivery of securities regulation, Coleman and Underhill (1995) and Underhill (1995) look at the worldwide emergence of arms-length securities agencies in the 1980s and 1990s, and their increasingly technocratic delivery of domestic regulation and transnational policy harmonization. They echo Michael Moran's (1991) finding that by "keeping governments out of politics", these institutional changes allowed for a rapid implementation of rules deemed necessary for the development of efficient global capital markets – changes, for instance, to disclosure and corporate governance requirements, and insider trading rules. Such changes would have been more laborious and contentious if undertaken by politicians concerned about the consequences of those changes for key constituencies (cf. Epstein and O'Halloran, 1999). Lutz (1998) notes that the internationalization of capital markets has led to the breakdown of traditional exchange governance practices, including self-regulation by stock markets and

private-sector led policy coordination at the domestic level. Her study of the German system of regional stock exchanges highlights the increasing role of arms-length public officials in the governance of that system, a finding that resonates with contemporaries who identified the emergence of a “regulatory state” in response to globalization (cf. Levy, 2006), or Vogel’s view that freer markets sometimes require “more rules” and greater public involvement in regulation (Vogel, 1996).

Other studies focus more on the content of global capital market regulation, and how those decisions are reached. For instance, Bach and Newman (2010b) focus on the global dissemination of new, US-style regulations for insider-trading. They theorize the mechanisms through which the US Securities and Exchange Commission has been able to bring foreign regulatory outputs closer to its preferences – i.e., by using both carrots and sticks that include memoranda-of-understanding, capacity-sharing, and the provision of access to US market resources for foreign private actors (cf. Gadinis, 2008b). Their investigation yields precise claims about how power is exercised between regulatory agencies, and explains where on the Pareto frontier regulatory outcomes end up, and whose preferences are realized as global regulations converge (cf. Krasner, 1991; Drezner, 2007). Work on the global regulation of hedge funds (Helleiner and Pagliari, 2009; Fioretos, 2010) has theorized the domestic sources of preferences regarding how major investors operate – how much risk they may assume, how leveraged their investments may be, what level of transparency they must offer investors and outsiders – in ways that are consistent with liberal IR theory (Moravscik 1997) and historical institutionalism in comparative politics (Thelen, 2004; Thelen and Mahoney, 2009; Farrell and Newman, 2010). Davis and Marquis (2005) offer a sociological explanation for the diffusion and development of stock markets and convergence of corporate governance regulations.

These dynamics are important to the cases investigated here, which can only be fully understood in a broader context, including: changes to the delivery of securities regulation (particularly changes to the self-regulatory role of exchanges); the development of new rules (such as the introduction of competition to the exchange landscape); as well as the international relationships between key regulators. Unlike these studies, however, which focus on processes of institutional and regulatory change as well as inter-regulator politics, this dissertation focuses on the relationship between public officials and the infrastructure firms themselves, which are a particularly significant – and underappreciated – locus of regulatory politics that is worth examining in its own right. As a result, this dissertation is better equipped to explain varying outcomes at the level of regulatory decision-making on the specific issue of cross-border market integration, rather than existing scholarship that effectively explains the broader institutional and legal context within which those decisions are taking place.

Indeed, another small body of scholarship looks in greater detail at exchanges themselves, and the interface between these private institutions and public actors. Two unpublished conference papers (Callaghan, 2010; Botzem, 2012) trace the emergence of for-profit stock exchanges through demutualization, and the impact of that structural change on the broader political economy in which exchanges are embedded. These studies add nuance to the theorization of institutional change, highlighting (as many such studies do) the role of changing material conditions as well as endogenous sources of change, particularly key actors' changing preferences and incentives as markets globalize (cf. Thelen and Streek, 2005). This dissertation is carefully attuned to these contributions: the theory of regulator dependence presented here considers the powers and preferences of both public and private actors in the exchange sector, especially given the introduction of competition in the industry (both within and across

jurisdictions, as capital market activity has globalized) and new commercial incentives. As argued above, these changes are the primary drivers of cross-border mergers and acquisitions.

Beyond political science, legal scholars have considered the implications of these changes in the exchange industry in greater detail than political scientists, and have effectively elaborated many of the political and policy dilemmas that these changes present to officials. Fleckner (2006) and Dombalagian (2007) examine how the demutualization of exchanges – their shift from member-owned to for-profit, publically-traded companies – has upset established divisions of regulatory duties across the public and private sectors. The appropriate division-of-labour between public and private actors has shifted as private exchanges’ incentives to adequately police their markets has (arguably) changed (Fleckner, 2006; Dombalagian, 2007). Many legal scholars (Fleckner et al., 2006; Pan, 2007; Karmel, 2007; Brummer, 2008; Dombalagian, 2012) have studied the impacts of cross-border trading and multinational exchange ownership on the capacity of regulators to independently assert their statutory authority – and have considered the implications for domestic systems of exchange regulation, both positive and negative. However, while these studies helpfully describe many of the political dilemmas facing officials (indeed, dilemmas that are central to this research project), they are not placed to offer predictions about how existing political institutions and political processes will mediate the pressures of a changing exchange market. Neither can they explain why observed decisions happen to vary across markets. That is where careful process-tracing can make a key contribution.

Two recent studies present scholarship that is close to the purpose in this dissertation. Callaghan and Lagneau-Ymonet’s study (2012) on the sale of the Paris stock exchange to NYSE, in 2006-2007, takes that event as a puzzle to explain, not least because of the French inclination

to interfere in the market for corporate control of important French firms – non-intervention by Paris is surprising. They develop an answer based on the availability of a discursive appeals to “economic nationalism” which is a helpful framework for studying the causes of outcomes in this single case, but of limited utility in studying variation across cases, as it focuses on a set of discursive variables that do not have explanatory power across all the cases studies in this dissertation.

Posner, too, has looked at the emergence of “new exchanges” in Europe (2009a). These exchanges have been set up to support the capital requirements of small and medium sized enterprises, on the early American NASDAQ model, an outcome that has been the target of policymaking efforts for decades – particularly as some European economies experiment with shifting from a bank-financing to market-financing model for companies. According to Posner, the development of these exchanges after years of failed attempts by domestic policymakers is an outcome that can only be explained if the independent policymaking role of the EU’s institutions is understood. He thus contributes to debates in International Relations scholarship about the power and purpose of international organizations, particularly in Europe. At the same time Posner notes that exchanges serve a particular public purpose that is of great interest to policymakers at any level (national or supranational) – an analytical focus that is shared in this dissertation. His empirical focus aside, however, Posner’s theoretical interest does not much overlap with this dissertation, which is less concerned with the dynamics of multi-level policymaking (although it plays a part in the DB-NYX case study) and is instead focused on the dynamics that take place between regulators and regulated entities.

To sum up, a small number of existing studies examine both the regulation of market-based exchange (including standards and trading rules, etc.) as well as developments within the

exchange industry – including regulatory and business strategy changes in that industry. This dissertation builds on this existing work by emphasizing two things. First, it looks at the *consequences* of many of these regulatory and market-structure changes more than their causes, examining in particular the increasing pressure on exchanges to develop cross-border business strategies. It then explains why public officials respond to those strategies in the ways that have been observed over the past decade. Second, and as mentioned, the dissertation emphasizes the dyadic relationship between public authorities and regulated firms, and demonstrates that this is a particularly important site of regulatory politics – and that public decision-making vis-à-vis financial markets can sometimes be boiled down to the dynamics that take place between officials and important market infrastructure firms, rather than between voters, politicians, or lobbying groups.

## CHAPTER III

### REGULATORY POWER AND MARKET INTEGRATION IN FINANCE

#### Introduction

This chapter contains two broad discussions, first on the nature and limits of regulatory power in finance, and second on public officials' decision-making with regards to cross-border market integration. In both circumstances the existing political science literature is assessed for the extent to which the endogenous preferences of regulators have been taken seriously on a causal level – that is, the extent to which political science has put regulators in the driver's seat as decision-makers with regards to market integration. In both cases the answer is that regulators have not generally been given that kind of causal role. Why does this matter?

The first discussion on regulatory power in finance establishes the important analytical point that integration can have significant impacts on the relative power resources of public officials overseeing firms and markets. What is more, it argues that certain 'tools of the trade' (such as coordination or unilateralism) that regulators can use to address cross-border market dynamics are not equally available and/or effective in all circumstances. Given the potential – and, crucially, *knowable* – impacts of integration on public sector power, the discussion therefore makes the case for taking regulators' preferences about integration seriously, particularly from the perspective of their capacity and autonomy to do their jobs.

The second discussion reviews the literature to assess the extent to which existing approaches to market integration in political science have, indeed, taken the preferences and concerns of market authorities seriously, and finds that with some important exceptions, this is an analytical gap in the literature to date. At the broadest level, the chapter argues that it is

curious that the predictable and knowable impacts of integration on regulatory power have not generally been positioned as *things that regulators care about when making decisions about integration*. This gap begins to be filled by the theory of regulator dependence, which is developed in the subsequent chapter.

### **The nature and limits of regulatory power in finance**

This discussion assesses the problems that global financial integration generates for public actors and their power over financial market participants. While it notes that the severity of those problems varies in important and interesting ways, depending on the product market and jurisdiction in question, it is also true that the negative consequences of global market integration for public power begs a fundamental question: why do public actors enable or allow global market integration in the first place?

The last chapter emphasized that exchange governance is an important site of political inquiry because of the distributional impacts and the potentially positive and negative social externalities generated by transactions that take place in the exchange industry. These outcomes are politically consequential. The discussion also noted the small literature that examines the distributional causes and consequences of exchange governance. For instance, the corporate governance literature has tackled the distributional issues related to the oversight of securities trading, and there is small literature that considers how regulators decide which public objectives to pursue for the securities sector, and why those objectives and preferences differ across jurisdictions (cf. Roe, 2003; Pagano and Volpin, 2005, Pinto et al., 2010; Lee, 2010).

Of course, a market authority's ability to achieve these outcomes through the regulation of private exchange and post-trading facilities, and thereby ensure that infrastructure firms fulfil

some set of broader public purposes, is also a complex issue. This question of public capacity has certainly become more acute as exchanges have demutualized and become publicly-traded, for-profit firms in the last two decades, rendering them less likely to behave as utilities and more likely to pursue a profit and shareholder value focused bottom line. In a general sense, the overlap between public and private incentives in the exchange sector may have decreased, as the provision of deep, liquid, well-regulated, transparent and fair markets is now only one of the many sets of priorities that demutualized exchange firms are motivated to pursue (Fleckner, 2006).

More significantly, the changed incentive structure facing exchanges has also led to pressures for those firms to integrate on a cross-border basis, as was also explained in the previous chapter. The cross-border integration of financial market infrastructures opens up a host of questions that have been robustly debated in international and comparative political economy to date – questions about the impacts of financial market integration on the autonomy of domestic policymakers, and the convergence of national economic systems and economic policymaking. According to this literature, it is probable that where a) exchange firms are private, b) capital is mobile, c) firms and capital straddle borders, and d) regulatory authority remains domestic, such a system is likely to have an impact on national market authorities' power over the market and its participants. Where markets are integrated as just described, a key question must therefore be asked: how did they get that way (cf. Helleiner, 1994)? It is indeed probable that authorities' ability to deploy their power and shape private undertakings on a cross-border basis is less than equal to their capacity to do so in the domestic space. The integration of market infrastructure firms is therefore a significant phenomenon in terms of the ability of

national market authorities to oversee and shape those markets, and their decision-making at such junctures is therefore rather important to consider.

Indeed, the ability of market authorities to deliver the policy outcomes they seek in the exchange industry is highly dependent on their ability to direct and compel for-profit exchange firms to develop and undertake private business strategies that complement (or at the least, do not undercut) broader political and policy goals. For public authorities to ensure that exchange firms deliver on those desired undertakings, they are likely to require significant levels of power and capacity – not least because the endogenous incentives of exchange firms to provide public goods may weaken in a cross-border commercial context. Power is thus crucial for public actors to oversee the exchange industry – indeed, to oversee any subsector of financial markets in which domestic public authorities have policy preferences that require complementary private sector undertakings, i.e., things that authorities must ensure firms actually do.

This discussion therefore elaborates a perspective on the scope of regulatory power and its sources, and notes that as it is often endogenous to important policy decisions, such policy decision should be scrutinized through the lens of regulatory power. The discussion therefore sets the stage, in the subsequent chapter, for the theory of regulator dependence which is, above all else, a theory based on regulators' power to get things done in the financial markets. In pointing to these public sector-based dynamics, the current discussion also makes a case for a more statist approach to the issue of integration in global markets (Kitschelt et al., 1999; Schmidt, 2002). The value of a more statist approach is reinforced in the second discussion, where the inability of existing approaches to explain specific integration outcomes in the exchange industry points clearly to the need for an alternative explanatory framework.

This discussion on regulatory power proceeds in four parts. First it provides a working definition of regulatory power in finance, borrowing from Cohen and proposing that the most significant components of regulatory power are capacity (defined as the capacity to control actors' behaviour) and autonomy (defined as insulation from external influence).

Second, the discussion assesses existing scholarship and draws out the varying perspectives on the extent of regulatory power in the transnational financial markets, and focuses in particular the challenges that cross-border market integration cause for public actors.

Third, the discussion analyses in depth how and why regulatory power in finance varies across markets and jurisdictions, noting that this variation makes it critically important to understand how differently integrated markets and jurisdictions got that way in the first place; and, finally, the discussion considers the limits to the effectiveness of some policy tools that public actors use to protect or augment their power over footloose market actors.

The purpose of these linked discussions is to establish that the impacts of cross-border integration on regulatory power are not uniform, but may vary significantly across markets, market authorities, and issue areas. Integration poses different problems for different authorities at different times. As such, the problems for public officials that are caused by global integration – namely the negative impacts on their capacity, and autonomy – ought to be re-positioned analytically. These policy dilemmas are not simply the consequences of integration: they may in fact shape the choices made by public authorities about cross-border market integration. Importantly, and as demonstrated by the literature surveyed in this discussion, those policy dilemmas can be more or less severe. The challenge, then, is to tie theory severity of these dilemmas to officials' revealed choices about integration in finance.

## **Defining regulatory power in finance**

Cohen (2006, 2008) has provided a workable understanding of power in finance that underpins the analysis in this and subsequent chapters. While Cohen's definition of power relates to the realm of monetary policy and politics (cf. Kirschner, 1995), it is both appropriate and useful to adapt it to the regulation of exchange infrastructure and exchange-based transactions. As Cohen writes,

Power may be understood to comprise two critical dimensions, autonomy and influence. The more familiar of the two is the dimension of influence, defined as the ability to shape events or outcomes. In operational terms, this dimension naturally equates with a capacity to control the behaviour of actors – 'letting others have your way', as diplomacy has jokingly been defined. An actor, in this sense, is powerful to the extent that it can exercise leverage or managerial authority. As a dimension of power, influence is the essential *sine qua non* of systemic leadership.

The second dimension, autonomy, corresponds to the dictionary definition of power as a capacity for action. An actor is also powerful to the extent that it is able to exercise operational independence: to act freely, insulated from outside pressure. In this sense, power does not mean influencing others; rather, it means not allowing others to influence you – others letting you have your way. (Cohen, 2008, p. 456)

While these two elements of power form the basis of both this discussion and the theory that follows, some minor clarifications and adjustments are necessary.

First, unlike Cohen's research, the focus on power in the dissertation is primarily (although not exclusively) on the exercise of regulatory power within the framework of domestic jurisdictional boundaries rather than across jurisdictions and between different market authorities

in the global system. That is, the focus here is on regulators' ability to get the domestic policy outcomes that they want out of the financial markets that they oversee, rather than the exercise of influence over foreign monetary policy decisions. It is certainly true that the exercise of power in the domestic economy can often involve coordination with outside actors or even efforts to apply rules and regulations on an extra-territorial basis, as is discussed below. However, the perspective advanced here sees the degree of influence and control in these cross-border contexts as an inherent problem that marks cross-border markets and market entities (even for powerful countries' regulators) rather than a dependent variable to consider – i.e., in this dissertation cross-border influence is the issue for authorities to consider.

For definitional purposes, it is therefore more useful and more appropriate to focus here on the “capacity to control the behaviour of actors” as a critical measure of regulatory power. Through this lens, the actors being controlled are domestic market participants, primarily (but not exclusively) private firms, and the measure of power on this scale is the degree to which those market participants undertake transactions, and investment and conduct activities that are consistent with the regulatory and policy objectives of the market authority. Regulatory capacity to shape market undertakings is the first measure of regulatory power, and here the focus is on the market undertakings of private firms.

The second measure of regulatory power is autonomy, and Cohen's understanding of the concept as freedom from external influence is entirely appropriate. In order to meaningfully pursue domestic policy goals, those goals must not be driven by the preferences or political activities of external agents seeking to extract rents from the resulting market outcomes.

Defining regulatory power as capacity over private actors plus freedom from external influence has several implications. It means that for regulators to have power, they must have:

- Sufficient resources (material and statutory) to compel regulated private actors to engage in wanted activities and adhere to regulations, principles, and rules - and to monitor that they do so;
- The ability to develop those regulations, principles, and rules with an emphasis on their domestic impact, in the context of broader domestic political and policy objectives;
- A significant level of private transacting and business activity taking place within the jurisdiction, giving regulators actual and not just nominal/statutory power over private sector activity.

It follows from this definition that any market or policy event that a) reduces regulators' relative or available resources, b) introduces foreign influence into their strategic calculus, and/or c) reduces the absolute level of private activity that they have the capacity and autonomy to control, also d) necessarily reduces their regulatory power.

### **Contrasting perspectives on regulatory power in finance**

The capacity of domestic officials to regulate and control global capital flows is the subject of an important empirical and theoretical debate in political economy scholarship. When capital markets and capital flows are significantly transnational in nature, how do policymakers and regulators ensure that they a) retain or attract desired business activity and b) direct it towards domestic distributional ends, without simultaneously eroding their power to achieve other domestic policy goals? What resources do public officials have when it comes to managing the private flows of global capitalism?

One answer is that domestic resources are fundamentally limited and constrained. The fact of international capital mobility has often been modelled as a structural constraint on the

autonomy and power of domestic policymakers (Haggard and Maxfield, 1996; Strange, 1996; Cerny, 1997; cf. Chwieroth and Sinclair, 2013). Under such conditions, the ability of policymakers to make independent domestic policy choices in the realms of both monetary policy and the setting of exchange rates has been theorized – and empirically observed – to be constrained (Obstfeld et al., 2005). What is more, regulatory and legislative decisions may be increasingly made with an eye to their impact on the relative attractiveness of the jurisdiction to footloose capital (Gill and Law, 1989; Goodman and Pauly, 1993; Haggard and Maxfield, 1996; Cerny, 1997). The key mechanism here is the private exit option, giving investment firms, banks, institutional investors and others with extensive capital resources a kind of 'structural power' over policymakers – ensuring that policy outputs do not even test the willingness of private firms to direct their business activities elsewhere. Domestic policy priorities that do not reflect private policy preferences are likely to lose out as the preferences of global financial players take on greater weight; the state's responsiveness to domestic distributional demands may subsequently be reduced. Domestic institutions may even come under pressure to change and converge in order to attract capital resources (Swank, 2002; Simmons and Elkins, 2004; Tiberghien, 2007).

This capital-as-constraint perspective frequently predicts a race-to-the-bottom across jurisdictions as they compete with one another for capital. More broadly, the literature emphasizes the incapacity of domestic public actors to establish independent policy trajectories. Domestic policymaking autonomy is weakened because of private firms' increased ability to exit the jurisdiction as a result of decreasing regulatory and technological transaction costs (Frieden and Rogowski, 1996), efficiencies that have been made possible in part by deregulatory and liberalization policy strategies undertaken in some (generally powerful) states (Helleiner, 1994;

Drezner, 2007). As the independence of domestic decision-making is eroded and inter-jurisdictional regulatory competition sets in, domestic policy tools like redistribution through taxation to fund social security, patronage-based public sector procurement, and monetary expansion become less feasible (cf. Garrett, 2000; Swank, 2002).

However, as Simmons has identified, this prediction does not match the empirical observation of "a general tightening of regulatory standards in a number of areas" relating to finance (Simmons, 2001, pp. 590). Indeed, another set of scholarship (as well as a significant universe of empirical cases) argues that the state's capacity to make differentiated, locally-relevant policy is very much intact (Garrett, 1998; Oatley, 1999). Domestic policymaking continues to result in variable outputs across jurisdictions, suggesting that states retain considerable freedom to act differently or to act on differing policy priorities (Kitschelt et al., 1999; Schmidt, 2002; Culpepper and Reinke, 2014). State power may simply be transforming in nature, and the tools state actors use may be evolving from a Fordian, social programme logic to a more regulatory logic (Ruggie, 1982; Vogel, 1996; Levy, 2006).

Indeed, even where state actors face pressures emanating from global markets, they are not powerless. As financial markets have internationalized over the past 30 years, public authorities have taken substantial measures to institutionalize oversight over those transactions and flows. Internationally coordinated efforts at overseeing financial markets are feasible, although the depth and degree of coordination at an international level has differed substantially from one issue area to another (Kapstein, 1989; Simmons, 2001; Singer, 2004, 2007; Gadinis, 2008b), as the feasibility of coordination depends on the incentives and power resources of the players involved; international outcomes may be characterized by power politics with distributional implications across the various parties participating in the harmonized regime (see

below) (Krasner, 1991; Simmons, 2001; Drezner, 2007; Leblond, 2011). Kapstein (1989), Pauly (1997), and Singer (2004, 2007) thus assert that state actors can use international policy coordination to jointly tackle policy problems beyond the remit of their territorially-bound authority and jurisdiction, and even use harmonization to avoid races-to-the-bottom, regulatory arbitrage, and other Pareto-suboptimal outcomes. Leading regulators may even lock-in the regulatory and market advantages of their home markets, and thus the competitiveness of the domestic markets that they oversee (Singer, 2004, 2007). Particularly powerful states may be able to project their preferences over both harmonization processes as well as exercise power unilaterally in order to achieve the outcomes they seek (Oatley and Nabors, 1998; Simmons, 2001; Drezner, 2007).

Observed here, then, are contrasting high-level perspectives on the power relationship between public officials and private parties in global finance. The predicted impacts of global financial integration on domestic policymakers' autonomy and capacity are also different, with both deeply pessimistic as well as more sanguine predictions being observable. It is worth nothing that which one of these two perspectives more accurately describes the public-private power relationship in global finance may well vary across issue areas, across jurisdictions, and across time (see below). For instance, the re-assertion of public demands for regulation and oversight in the immediate post-Crisis period could be read as a changing balance of power – or at least normative resources – between regulators and the firms they regulate, although final judgement on this is ripe for debate (Helleiner and Pagliari, 2011). What does seem more unambiguous is that financial firms with mobile assets and activities extending across borders present a set of challenges for regulators. At the very least such mobility appears to compel new forms of cooperative and coordinated governance efforts across borders, always a difficult

undertaking in itself. At the other extreme, that same mobility may handcuff officials into offering domestic policy concessions to footloose firms.

Further complicating the effort to measure the extent of public sector power over financial service firms is the increasing prominence of private governance and authority in global finance. The delegation of standardization and coordination activities to quasi-private bodies like the International Accounting Standards Board and Financial Accounting Standards Board for accounting standards, or the International Swaps and Derivatives Association for OTC derivative regulation, and to public international standards setters like the International Organization of Securities Commissions (IOSCO), adds a layer of partly public and partly private authority to the international financial market policymaking landscape.

These arrangements have political histories that explain their development, and also have distributional impacts that political actors may have to subsequently manage (Perry and Nolke, 2006). Buthe and Mattli (2011) argue persuasively that this system of privatized global regulation generates winners and losers, empowering some domestic standard-setters (and the firms they represent) more than others. They observe that producer groups in states where regulatory authority is consolidated are particularly well-positioned, because the existing domestic centralization of authority enables regulators to more effectively upload both their preferred standards and those of domestic firms to a private international standards body. Underhill and Zhang (2008) see more fundamental issues of accountability and legitimacy at stake in the privatization of global governance, and worry about the power imbalances that emerge from the asymmetrical distribution of technical knowledge and financial resources – both across jurisdictions as well as across the public and private sectors (see also Mugge, 2011). For Underhill and Zhang, private governance is a manifestation of a broader problem of regulatory

capture, where for a variety of reasons including issue complexity and organizational advantages, private interests are able to assert and lock-in their preferences for the management of the global economy.

Private governance, however, poses a challenge to public authority even where the epithet of ‘capture’ does not apply. It is important to observe that the development of private governance arrangements can represent a strategic public sector choice about the benefits of delegating governing power to non-state entities (cf. Epstein and O’Hallaran, 1999), and so private authority is not obviously and only a source of weakness for the public actors making those initial delegation decisions. At the same time, such arrangements both legitimize and institutionalize the exercise of private decision-making and the influence of private preferences in the development of public policies and market rules. Moreover, in many cases, authority is not ever delegated – material and substantial policy decisions are made via self-regulation because their technical complexity means that private bodies are the first and only ones to tackle them, even if later those rules have implications that resonate beyond the industry that is standardizing them in-house. Self-regulation in the OTC derivatives and hedge fund industries have historically fit this latter characterization, which has since led to significant political battles across jurisdictions, through global regulatory bodies, and between public and private actors, pitting those seeking to re-establish public authority over the OTC markets in the wake of the financial crisis against those wishing to maintain a light-touch regime (Helleiner and Pagliari, 2009). The entrenchment of private capacity and interests in the global regime that governs the OTC and hedge fund industries is a clear challenge for the domestic authorities who have subsequently tried to bring transparency and stability to those markets. It is important to

observe, too, that the private entities backing global regimes of this type are overwhelmingly multinational rather than domestic firms.

Furthermore, the outputs of private regulatory systems are not only shaped by domestic institutional arrangements, as Buthe and Matli argue (2011), but are also likely to have impacts on the subsequent operation of domestic regulatory systems – and on the ability of public actors to effectively monitor and oversee domestic markets and manage the markets’ knock-on impacts on taxpayers, pension holders and other domestic stakeholders. This impact may be felt where private market rules provide insufficient cover against risk-taking or opaque transacting, thereby working against public regulatory goals – as in the OTC and hedge fund cases above. But more generically, internationally harmonized private standards produced by international financial market actors may simply hamper the ability of domestic authorities to shape policies and regulations to the particular needs of the domestic environment – for example, the development of particular securitized products that serve a domestic niche but fall afoul of global best practices around disclosure or collateral management. The private governance network provides a source of power and coordination for private firms seeking the coordination and standardization of rules rather than domestically-tailored ones (Farrell and Newman, 2014a). This also suggests that where private firms possess some measure of regulatory, standard-setting, or monitoring authority, the international expansion of their private activities may complicate the exercise of public oversight over how those self-regulatory activities proceed.

In sum, private international standard-setting, and the increasing interpenetration of jurisdictions and expanding market activity by firms whose activities are governed by private standards, is a challenge for domestic policymakers. Managing the material impacts of private financial standards and reregulating those domains, or ensuring that global market actors develop

standards that are appropriate for the domestic economy, are far from straightforward exercises for domestic policymakers.

These perspectives point to the significant power of private interests, to both press for and then lock-in processes of international market integration and liberalization. Most observers agree that regulators are, if not simply captured, at least highly influenced and structurally constrained by the preferences of global producers of financial services. Foreign exchange traders move capital effortlessly in response to policy decisions, sharpening the relative costs of those decisions; financial service producers locate their investment and management activities where regulatory and political models best contribute to their bottom line, weakening public actors' freedom to design those models; and private actors build globally harmonized regulatory systems that reflect their interest in lower transaction costs and profit-making over domestic distributional priorities, in ways that are very difficult for public actors to counteract and undo. This suggests that market authorities wishing to preserve their autonomous capacity to make policy should have at least some incentives to prevent the emergence of cross-border flows and globally-active firms – such as market infrastructure firms – which may limit or constrain the future exercise of public power in the market.

But in this vein, it is again important to balance these pessimistic accounts of the capacity of public authorities to autonomously govern private flows against the more sanguine views on the public-private relationship in finance. To paraphrase Polyani, global finance was planned (1944). Indeed, the emergence of an integrated global economy is also the result of a series of discrete policy interventions by actors with ideas and preferences about how best to position their economies, enable economic growth and generate efficiencies, and respond to exogenous developments like technological change. Part of the story of global finance is surely about

private lobbying, information asymmetries, and coercion by both powerful states and corporations – but it should not be missed that policy choices can often remain choices in at least some sense, and that transatlantic market integration, capital mobility, and cross-border firms are all allowed and allowable under some set of rules and regulations that enable those market transactions (Helleiner, 1994; McNamara, 1998; Abdelal, 2007; Watson, 2007; Chwieroth, 2010).

These contrasting perspectives on the power of the public sector relative to global market actors and firms lead to important empirical questions. What power resources do public actors have in this system, and how do they use that power to shape the emergence of global markets? If global finance is ‘planned,’ do public actors ever block the emergence of global financial markets and firms because of the negative impacts on their domestic autonomy and capacity – i.e., the potential impacts just detailed? Why choose integration, and/or why stop it?

### **Variability of regulatory power**

To more accurately describe the nature of the dilemma facing market authorities making these decisions about integration, it is helpful to add nuance to this discussion about the extent of their capacity and autonomy. Market authorities’ power is not simply a matter of perspective on the macro-structural impacts of globalization. Empirically, public power varies, and it varies not only with obvious correlates like market size, but also with jurisdictional boundaries and with policy choices relating to market structure – i.e., whether a given product market is domestic or cross-border in nature. Power varies with policy decisions about the structure of market and its oversight. This observation is crucial for setting up the theory of regulator dependence to explain varying public responses to mergers.

With regards to the power of public actors to shape outcomes in private financial markets, one perspective with intellectual roots in the realist tradition in IR points to the market power of individual states, particularly over trade regime outcomes (Hirschman, 1945; Krasner, 1976). A dominant or hegemonic market can build an international regime that suits its preferences, particularly in a context where other states are highly dependent on products only available through trade (i.e., in contexts where the fungibility of hegemonic exports and the elasticity of foreign demand are both low, and the fungibility of foreign imports into the dominant market is high).

As in trade there are good theoretical reasons to expect a power advantage for hegemonic states in global capital markets, especially as the liquidity and depth of financial hegemons' markets are very difficult to replicate (Kirschner, 1995). This is true in their relations with authorities in foreign markets (Drezner, 2007; Bach and Newman, 2010b) but also in how they are able to influence both the incentive structures and opportunity costs that motivate foreign firms. In this perspective, both policy outcomes and global regulatory regimes are shaped by the policy choices of market authorities in hegemonic states, due to the subsequent activities of domestic interest groups in both the hegemonic states and in other markets (Frieden, 1991; Frieden and Rogowski, 1996; Moravscik, 1997; Mugge, 2006; Drezner, 2007; Posner, 2009b). Where one state – or, as has historically been true in finance, two states, the US and UK – have a distinct market-power advantage in terms of the depth and liquidity of their capital markets, foreign firms will seek access to those markets in order to enjoy the liquidity and ancillary service benefits they offer, including lower capital and transaction costs as well as profit opportunities (Simmons, 2001; Gadinis, 2008b). Policy convergence towards the hegemonic markets' will result, as firms seeking access to the large market will often unilaterally adopt the

large market's standards as a precondition of gaining access. On the public side, foreign regulators will come under pressure from their domestic firms to adopt standards similar to those demanded in the large market. Similarly, the interests of domestic firms in the dominant markets will be exported abroad during liberalization negotiations or other interactions involving the dominant market's officials.

This mechanism may lead to either more or less stringent regulatory standards – it does not predict the direction of regulatory change. In what has been called the 'California effect', it can indeed lead to a 'race to the top', as global standards converge on the higher standards of the dominant market (Vogel, 2000). This is a debate of particular relevance with regards to the convergence of global securities markets and regulations. As mentioned in the previous chapter, in American capital markets, studies frequently show that issuing firms pay a lower risk premium to their investors than do firms in other equities markets around the world – this is due at least partially to the American SEC's reputation for high standards and rigorous implementation of investor protection strategies (Coffee Jr., 2007). This dynamic suggests that as securities regulation has harmonized worldwide it has not followed a race-to-the-bottom logic but instead has often featured convergence towards the more stringent and costlier American standards (Bach and Newman, 2010b). A similar story is observed in the ongoing US-EU conflict over their mismatched accounting standards, a conflict which has been driven by the interests of private users of those standards and the investors who depend on them (Eberle and Lauter, 2011; Leblond, 2011). It is also observable in the more recent debates about the implementation of the latest Basel III regulatory capital requirements for banks, and the EU's bank capital rules in particular. In this latter case French policymakers have reportedly sought an upper-bound cap on regulatory capital ratios so that relatively well-capitalized British banks will

not have a structural and reputational advantage over their French counterparts, demonstrating a fear of a British-led race to the top that French banks cannot compete in (Howarth and Quaglia, 2015).

These power-based analyses suggest that regulatory power in global finance is a privilege of large states possessing deep and liquid capital markets. It therefore follows that the structural power of mobile capital has a more profound impact on the power resources of officials in small markets than those in large markets - that is, the autonomy and authority of small market officials is eroded more quickly and severely than that of large states, because the preferences of foreign market authorities and large financial service producers trickle in and interfere with the discrete policymaking powers of the small market officials (Andrews, 1994; Haggard and Maxfield, 1996; Mosley, 2003). The attractiveness of large markets to private actors – due to their depth and liquidity, as well as knock-on advantages in services, expertise, and fees – enables authorities overseeing those markets to dictate where on the Pareto frontier international regulatory outcomes converge (Krasner, 1991; Bach and Newman, 2010b).

In addition, this market depth makes the threat and the impact of firm exit less significant for large markets than small. The effect here is that deep and liquid market regulators can pursue at least some unilateral regulatory change without the fear of capital flight (Culpepper and Reinke, 2014). It can even be argued that at a certain degree of depth - after an unspecified "tipping point" – capital markets are more like natural resources or commodities that reside in the ground than the electronic marketplaces of "spaceless flows" that they are so often characterized as, flows that can move anywhere instantaneously (Castells, 1996). The logic here is that the opportunity costs for private financial firms of exiting a large and liquid market are often greater than the transaction and compliance costs of staying and complying with newly-imposed and

onerous regulatory obligations; the opportunity costs of exiting a small market are unlikely to be as large. The effect is that small state regulators must be responsive to the potential migration en masse of financial service firms and their market transactions: attracting and maintaining liquidity is a different game in small markets than it is in large markets. However, markets like New York, London, and Hong Kong offer substantial liquidity benefits as well as direct access to competitive ancillary services in legal, accounting, and other professional industries. Exit is simply a costlier option for firms operating in these locations, particularly when defined as opportunity costs. This is a network effect with substantial positive externalities for large and liquid markets, and potentially negative externalities for small ones (Lee, 2010, pp. 15-18). The overall outcome is, again, that international capital mobility is more of a constraint on the policy autonomy of some domestic authorities than others (cf. Andrews, 1994).

These variable impacts of capital mobility on the autonomy of state actors are noted in a second and more recent perspective, one that is focused more on the impact of institutions on incentives than on the effect of differential market power. In this perspective regulatory power – defined as the capacity to bring global regulatory outputs towards one’s ideal point – is a function of a) jurisdictional boundaries and b) market structure. Power can clearly vary with market size, but it does so in a non-linear fashion, and how it varies is shaped by institutional factors that go beyond simply market power measured by size, breadth, and depth (Posner, 2009b; Bach and Newman, 2010a; Farrell and Newman 2014b). More specifically, changes in a) the degree to which markets are internationalized and b) the jurisdictional scope of regulatory authority (i.e., transnational or domestic in scope) inform how regulators interact across borders, as well as the incentives that shape private firm decision-making. The boundaries of markets and jurisdictions thus shape who wields power in both state-firm and state-state relationships.

Indeed, shifts in jurisdictional boundaries and market structures can make it more or less possible for regulators to influence firm-level decision making and investment activities.

Newman and Posner (2011) have built a typology that demonstrates exactly how these market and jurisdictional variables affect regulator power (see also Gadinis, 2008b), and they argue convincingly that under conditions of economic interdependence the regulatory power resources of various market authorities will be a function of those variables. So, where both markets and jurisdictions are contained within contiguous sovereign borders, market power is indeed the determinant of regulatory power – this scenario gives rise to the market power-based mechanism discussed above. Where authority is national but markets have liberalized and are transnational, however, market power ceases to predict who will have regulatory power. In such a situation, mobile and footloose firms may engage in arbitrage activity, moving business away from the dominant centre towards a less stringent location, where compliance costs are lower, sometimes known as the ‘Delaware effect’. This explains, for instance, the out-sized capacity of policymakers in micro-state tax havens Liechtenstein, the Cayman Islands, and the Channel Islands to shape corporate and capital gains tax policy in the world’s biggest economies (Palan et al., 2010). Both collective action problems and first-mover advantages are more pronounced in such a market, as the content of regulations rather than market size determines the winners and losers among jurisdictions. In such a context, regulators with carrots (attractive regulations) also hold sticks (power over business taking place in their jurisdictions, particularly enforcement capacity over real transactions).

A key example illustrating the importance of both market and jurisdictional boundaries is the increasing consolidation of regulatory authority over European capital markets in Brussels, and particularly in the European Commission and related rulemaking and supervisory agencies

like the European Securities Markets Authority, European Banking Authority, and the European Central Bank. Bach and Newman (2007), Posner (2009b), and Posner and Veron (2010) have argued convincingly that changing jurisdictional boundaries in Europe and the expansion of European regulatory capacity explain the EC's increasing ability to influence global financial regulation, rather than an increase Europe's market power through the Single Market or even any changes to the policy content of European financial regulation. For Posner (2009b) the mechanism behind this claim is quite simple. As more Member State jurisdictions are regulated and overseen by Brussels-based institutions, more and more firms are implicated in EU policy outputs. Importantly, this includes not only European but also global (American, Japanese) firms with operations in Europe. These firms then lobby their home market supervisors to cooperate with European authorities, not only as a more credible partner who is accountable for a large percentage of the world's capital market activity, but also as a single-point authority with the potential to enact broad-reaching reforms that have impacts on the profitability of their entire European operations.

What, then, emerges from these perspectives on the variable nature of regulatory power in global finance – one perspective focused on market power, and the other based on a more dynamic set of variables? The central point here is that regulatory power in finance is fluid rather than static, and that the power available to public actors is shaped by three sets of variables:

- Market size, depth, and liquidity (i.e., which markets pull on participants?)
- Market structure (i.e., are flows – production and consumption – national or transnational?)

- Jurisdictional boundaries (i.e., is the implementation and enforcement of regulation domestic or extraterritorial? National or supranational?).

As discussed, these variables determine regulatory power largely because they structure the transaction and opportunity costs of private firms. Where firms want to do business is central to the conception of regulatory power offered here. Private firms' ability or inability to avoid unwanted compliance costs and choose alternative regimes with which to comply is critical to determining whether or not regulators' have actual (and not just nominal and/or statutory) power to attract market activity and shape the capital markets in ways that address domestic political and policy goals (Singer, 2004, 2007). The degree of private firms' structural power over the decision-making of public market authorities is, as a result, driven by policy decisions about the overall shape of that market and the structure of oversight over it.

It is therefore potentially valuable to view these policy decisions as endogenous – each may represent a political choice rather than a given feature of the political and economic environment. As Newman and Posner (2011) rightly observe, there are degrees of product market and firm internationalization. At one end markets may be completely transnational, in which ownership and the market for corporate control are unrestricted by nationality and where goods and capital flows across boundaries with minimal frictions. At the opposite end may be a domestic requirement for corporate ownership and management, and the delimitation of certain categories of market transactions to within a jurisdictional boundary. However, where Newman and Posner examine the impacts of change in the scope of markets and market authority on regulators' power, this dissertation proposes to more fully endogenize the varying types of market and jurisdictional structures that can be observed in the financial markets. As a result, differing degrees of alignment between the boundaries of product markets, service-providing

firms and regulatory authority are not an independent variable in this dissertation, but represent political choices. The transnational scope of capital market activity is shaped not only by private decisions about where to do business once they are allowed to make those decisions freely, but also by earlier public decisions about a) the regulation of capital flows, b) the ownership, control, and governance of systematically important firms, and c) the types of transactions that those firms are allowed to facilitate, execute, and participate in.

The endogeneity of market structure described here is particularly significant given its relationship to regulator power. If market structure – and the corporate structure of important firms – is considered to be endogenous, and if that structure shapes the power resources of the regulators who oversee those markets, then interesting questions emerge. How do regulators make decisions about firms seeking to integrate across borders and stretch their production patterns or product markets into new jurisdictions? What makes the choice to allow (block) such a private integration effort more or less rational, or more or less probable? If levels of domestic regulatory power are at least partially endogenous in these ways, when is it protected?

### **The tools of the trade: strategies to project or augment power**

A final discussion argues, again, for the view that public power over global financial markets is variable – and points, again, to the value of looking at the level of market integration as a policy choice that is endogenous, rather than exogenous policy structure with impacts on public power.

This discussion unpacks three of the ‘tools’ that domestic policymakers have been theorized to deploy in order to manage global capital flows – those tools being cross-border coordination, domestic network-based coordination, and unilateralism. The section shows that

these tools are not universally a) applicable, b) functional, or c) rational for authorities to depend upon. In short, they may not work for everyone. Given this lack of fit between the ‘tools of the trade’ and the interests of the market authorities who might use them, it is again interesting to ask – when will these tools enable the management of an integrated market environment, and when might an alternative approach that avoids integration altogether be desirable?

Cross-border regulatory coordination between multiple domestic authorities can be rational where a unilateral approach is likely to result in comparative disadvantages and hence disproportionate costs to domestic producers, but where a failure to enact regulatory or policy change is also likely to result in costs that are borne by domestic groups, in the form of instability or unemployment (Kapstein, 1989; Webb, 1995).

One key component of this approach is to encourage policy convergence across several jurisdictions and therefore minimize firm-side regulatory arbitrage opportunities. Singer's work (2004, 2007) on the domestic political economy of regulators' incentives to coordinate (or not) with foreign regulators is a recent and widely-cited example of this perspective. Because of a crisis or exogenous material shock in the financial markets, a regulator can come under domestic pressure from their legislative principles to re-regulate and bring more stability and transparency to the markets. However, doing so has the potential to erode the relative competitiveness of the market – which will also result in legislative pressure on regulators, due to the probable impacts of greater regulatory stringency on economic growth and job creation. In such circumstances, international coordination that brings all major regulators closer to the new and more stringent regulatory standards may be a rational pursuit, because it leaves firms without an attractive exit option, and makes them more willing to bear the increased costs of a re-regulated domestic

environment. Under the right conditions, coordination is a better choice for many regulators than a potentially-costly unilateral policy change, one that could result in firm exit.

This is not, however, equally true across policy domains or across markets. Variations in the *ex ante* competitiveness of jurisdictions as well as the content of proposed policy changes may make such collective action highly unattractive and improbably difficult. Highly competitive markets – or jurisdictions whose firms are well-positioned because of existing rules and standards – can be reticent to fully adopt more stringent rules. As a result, many issue areas continue to resemble the distributional power game elaborated by Krasner (1991), Oatley and Nabors (1998), Simmons (2001), and Drezner (2007), in which incentives to cooperate on the part of key regulators remain quite limited. Moreover, even where coordination is more rational than unilateralism, it is far from obvious that small markets are able to secure harmonized policy outcomes that reflect their interests. Harmonized policy outcomes are unlikely to be free from power politicking. An alternative to coordination that carries a greater likelihood of delivering policy outcomes proximate to regulators' preferences and that does not negatively affect a market's international competitiveness is thus highly rational and attractive – particularly to small-state regulators likely to lose in a global coordination exercise.

This hypothesized small-market-regulator distrust in cross-border regulatory cooperation is exacerbated by some probable firm-level incentives. Where product markets stretch across jurisdictions due to liberalization and producer firms similarly operate across jurisdictional boundaries, and the integrated jurisdictions feature markets of different sizes or levels of competitiveness, it is reasonable to expect that the smaller or less-competitive member of the dyad will be uncertain about sharing power with the regulator of the larger market. This is because the merging firm will likely have incentives to concentrate its business activity in the

larger market, and as a result will be more responsive to – and more connected with – the regulator of that large market. As a result, the regulator of the smaller market may rationally associate the merger with a gravitation of regulatory power abroad, even with (or indeed because of) a promise of policy coordination.

Coordination is, in short, only desirable for a regulator who believes that the policy outcomes it generates will be advantageous relative to the status quo or at least better than a failure to engage in collective action. Avoiding the need to coordinate altogether – i.e., by keeping some key policy area as isolated as possible from international flows and foreign influence, or by not allowing a product market to stretch across jurisdictions – is, if possible, an attractive alternative in some instances.

The second mechanism, network-based coordination, describes a domestic system through which the comparative advantages of the productive economy are locked-in by the private undertakings of firms. Firms possess incentives to reinforce and buttress those domestic comparative advantages in a particular type of production or sector because their own viability is tied to the ongoing provision of collective goods (Hall and Soskice, 2001). Firms and their stakeholders can use the stability of long-term expectations, centred around joint investments in particular systems of production, to ensure the viability of their business models even where the relevant product markets are expanding across borders. Even short of such endogenous coordination by firms in particular types of coordinated economies, public officials may be able to use informal network resources to influence and shape the preferences of major domestic financial service producer groups in ways that push those groups towards private undertakings that are consistent with broader political and policy goals (Hall, 1986; Evans, 1995).

This tool may weaken or break down. Economy-wide coordination is clearly only effective as a power resource if the network through which it takes place remains in place, enabling coordination between domestic actors and providing them with the autonomy to make policy decisions that meet the challenges of openness and integration (Katzenstein, 1985). A breakdown in the network may indeed be a costly side-effect of integration – or even an *ex ante* reason to oppose cross-border integration (cf. Callaghan, 2014).

The mechanisms of influence and power within a domestic policy network may be twofold – one ideational and one institutional, but mutually reinforcing (Farrell, 2009):

- Cultural and epistemic effects: power is transmitted through shared definitions of problems, consistent views and expectations about policy solutions, personal relationships and social activities, and mutual understandings of legitimate levels of state regulation and market oversight (Gerlach, 1992; Campbell, 1998; Abdelal, 2007; Farrell, 2009; Fligstein and McAdam, 2012)
- Equilibrium dynamics: Increasing returns to scale can be enjoyed by private actors who have a) expectations of stability in the regulatory environment, b) incentives to make investments in business activities that produce positive social externalities (such as economic growth) as well as private rents; and c) lack exogenous incentives to defect from this equilibrium (Hall and Soskice, 2001). In rationalist analyses these equilibria are often modelled as the result of atomistic actors pursuing their self-interest within a stable institutional context, which may lead them to enact changes when those institutions no longer suit their preferences (Thelen and Streek, 2005). However, the stability of these arrangements – that is, their self-reinforcing nature – may also be augmented by

commitments, social ties, expectations, and trust, thereby helping to deliver actors to coordinated outcomes (Farrell 2009).

These networks are substantially material and face-to-face in nature. Geography and proximity, far from being irrelevant in transnational finance, can in fact lead to public-private networks with strong socio-spatial characteristics (Fligstein, 2001; Wojick, 2011). Common cultural, epistemic, and ideological perspectives on regulation and business activity, shared across the public and private sectors, can shape the development and trajectory of particular financial markets (Sinclair, 2000). Personal relationships are a key element of this system, as are shared beliefs about the appropriateness of various goals and tactics, and the desirability of outcomes. Business activity is also often highly parochial, as expertise and knowledge builds up around certain business strategies (like an emphasis on certain specializations or sub-markets), and expectations align around certain processes of doing business, leading to highly-ingrained expectations. This takes place via informal institutions like regular meetings, common language and shared social activities, as well as the development of formal expertise, such as familiarity with disclosure rules, bankruptcy laws, and other legal conventions. For these reasons there is a robust "home bias" in investor cultures (Strong and Xu, 2003) – to give just one example with clear significance within the exchange industry.

These spatially-bound characteristics of financial market governance may be eroded by cross-border market and firm integration, representing the loss of a key resource for public officials seeking influence over private outcomes in general, and a specific firm's private undertakings. Cross-border mergers of private financial service firms, particularly at the level of management, is especially likely to reduce the effectiveness of domestic systems of

coordination, especially if it results in changes to the corporate governance and oversight structure of the firm.

Each of these network-based mechanisms of influence and power can be undercut. The use of domestic coordinative strategies to augment or protect existing comparative advantages, existing policy programs, or desired market outcomes may not be as effective or even plausible under conditions of integrated markets or market infrastructures. Even in a rationalist equilibrium-based perspective, opening a private firm to new incentives can lead to broader pressures to change. An authority that depends on informal network-based resources to drive its policy agenda would be highly rational if it tried to impede cross-border integration, i.e., avoid the loss of those resources.

Finally, policy unilateralism is an option, especially for regulators of large markets. The result may be a convergence towards the policies of the dominant market (Krasner, 1991; Vogel 2000), for market-based reasons that were elaborated above. However, it is not always the case that a unilateral move is effective. It can lead to negative externalities that reduce future bargaining power and a declining utility curve for the unilateral mover (Simmons, 2001). This is especially true where opportunities for exit and alternative investment opportunities exist or are emerging, as is the case in contemporary finance with the emergence of alternative European and East Asian capital markets. Unilateralism can also harm the reputational resources available to a market authority in a system in which interactions between parties are repeated and iterative (Brummer, 2012, pp. 150-160).

In fact, unilateralism is largely effective only if the domestic marketplace is a 'draw' to firms: i.e., that any negative externalities associated with regulatory changes are lesser than the opportunity costs and transaction costs associated with exit.

In terms of opportunity costs, this means that the depth and liquidity of a marketplace attracts private actors more than inefficient or costly regulations in the same marketplace repel them. In terms of transaction costs, this means that the frictions for business associated with unwinding operations in one jurisdiction to set up elsewhere, or moving transactions (and thereby management and administrative capacity) abroad, remain greater than the costs associated with adjusting to regulatory change in the domestic market. Logically, this is more likely to be true if the costs of exit remain relatively high. As discussed above, however, changes in market structure have an impact on the relative power resources of market authorities precisely because they can have an impact on firms' relative pricing of the exit option (Newman and Posner, 2011). Where the cost of exit is low, even highly competitive markets can be undercut by upstart jurisdictions offering a cheaper regulatory burden. This cheap exit dynamic is, of course, even more likely if the market structure is cross-border in nature, i.e., because of integration through regulatory liberalization and/or integration of private financial service firms.

Short of an equilibrium where the costs of exiting the unilaterally-reregulating market outweigh the costs of staying in the unilaterally-reregulating market, capital flight and/or the migration of substantial levels of business activities abroad are plausible outcomes (even for large-markets with deep and attractive capital pools). This is especially true once a financial service firm has integrated across borders and is therefore highly capable of offering services and making profit in multiple jurisdictions. This increases its ability to redeploy capital and business energy in foreign jurisdictions but within the same business firm, i.e., to its branches or subsidiary units. It may even encourage its users and clients to do the same by allowing them to transact across borders with fewer costs – thereby "selling" different regulatory environments through a single corporate window (Brummer, 2008). The loss of the unilateral policy option –

or even its degradation as a viable and effective choice – suggests a reason to look more closely at decisions enabling the integration of financial product markets and financial service firms.

This discussion suggests that the problems that public officials face as a result of cross-border financial integration will not necessarily be practically or effectively managed with the tools that they have at their disposal, which can be expected to make officials hesitant about integration. What is more, and as this discussion has made clear, these difficulties are predictable *ex ante*, given that a) the probable incentives of firms with international operations as well as b) the power dynamics between large and small state regulators jointly overseeing an integrated product market and/or firm ought to be at least partially foreseeable to policymakers. In short, the unavailability of these tools after integration has taken place can certainly be seen as a *predictable* loss of power for domestic authorities.

As a result, it is worth considering the conditions under which policymakers seek to avoid that loss of power, which is precisely what the theory of regulator dependence sets out to do.

Indeed, the manifold challenges to public power that have been discussed here are in fact the basis for the strategic calculation made by public officials confronted with a discrete (yes or no) integration decision. In fact, perhaps the most important inference generated by this discussion is that this decision point is indeed a strategic calculation for public officials. This is because the impact of financial market integration on regulatory power is not uniform in all circumstances: public power is not always eroded by financial market integration to the same extent and degree, and it may even be offset by gains in some circumstances. The capacity and autonomy of public actors varies with their market size, with policy choices about market

structure and extent of integration; and with the choice and effectiveness of the policy tools used to manage the externalities caused by integration.

These findings suggest that policy choices about integration ought to be theorized and endogenized in ways that capture the varying and dynamic impacts of integration on the power of public officials. The chapter now moves to review the existing literature on integration – particularly but not exclusively financial market integration – to determine the extent to which political scientists have endogenized the impacts of integration on public power and autonomy in their models of public decision-making, and indeed the extent to which they have considered public officials’ autonomy preferences at all.

### **Assessing explanations for financial market integration**

The chapter now moves to assess the degree to which the existing literature takes account of the issues raised in the previous discussion on regulatory power. It examines the treatment of cross-border market integration in the existing literature, particularly the mechanisms through which public authorities are theorized to enable or impede the international integration of market flows. It shows that, with some important exceptions, the phenomenon of cross-border integration is not generally explained in a way that takes account of the dilemmas that public authorities face when confronting integration proposals – not least the potential impacts of integration on their autonomous capacity to govern their domestic markets as they see fit. These dominant approaches are certainly empirically grounded in many instances, i.e., where lobbying, power relations, or neo-classical ideology explains the genesis of a cross-border market. However, in other markets and policy areas, and particularly in the discrete decision-points where integration is an all-or-nothing proposal – including the exchange issue area at the core of

this dissertation – public decision making may, in fact, be driven by regulators’ *sui generis* considerations about power, autonomy, and the realization of domestic policy goals. This argues clearly for a theoretical approach that goes beyond existing treatments of public policymaking vis-à-vis market integration, treatments that emphasize the lobbying power of firms, the effects of institutions on the aggregation of preferences, the opportunity costs of autarky, or the normative power of ideas, rather than the interests and preferences of market authorities who want to do their jobs well.

The chapter concludes with a review of studies that consider the linkages between public officials’ policymaking efforts and the private initiatives undertaken by multinational corporations, finding important inferences in that literature that point to the need for a tighter theoretical link between firms’ commercial undertakings and the regulatory response to these commercial activities. These discussions set up the theory of regulator dependence proposed in the subsequent chapter, a theory that takes the independent policy concerns and policy preferences of state actors vis-à-vis integration seriously.

Explanations for the international integration of markets tend to be either systemic or domestic in nature – that is, the mechanisms driving policymakers’ integration decisions emanate from either the global system or from within the domestic political system. As is demonstrated in this analysis, only very few perspectives on integration consider statist or public sector variables as causally independent. Public responses to the impacts of integration on national policy autonomy and the realization of domestic policy goals – i.e., considerations made by domestic authorities about their power in an integrated environment – are not analyzed causal factors shaping the degree of integration that is allowed by policymakers.

A recent study drives home the value of considering these *ex ante* dilemmas. Epstein (2014b) studies the interaction between firm-level business incentives and international public policy outcomes. Her puzzle is, why didn't western European banks flee central and eastern Europe during the Eurozone crisis, and repatriate their capital from their host markets to their home markets? Previous crises (in Argentina and Turkey) have seen exactly this behaviour by foreign banks. As she puts it, 'European bailouts were nationally oriented' and so there was a concomitant expectation that the crisis and response would result in a repatriation of capital to the banks' home markets. National regulators and even the European Commission contributed to this pressure to repatriate capital by ring-fencing economies from one another through nationally-delivered bailouts and pushing hard for domestically-focused liquidity and lending activities on the part of the banks. The Vienna Initiative – a multilateral, public-private condominium brokered by European supervisory institutions – is generally credited with preventing the 'cut and run' outcome by coordinating a 'soft landing' in the central and eastern European banking sector. Epstein argues instead that the banks stayed put because of the business model they had adopted, which was a 'second home market' subsidiary-based model rather than a foreign branch model. She calls this effect the 'stabilizing role of subsidiaries', which ensured that the banks had strong business incentives not to abandon their secondary markets of operation. In fact, the Vienna Initiative was epiphenomenal, and was used as a signal by the banks – i.e., to publicly communicate their interest in remaining in the Eastern European economies, and so to signal that commitment to investors and to regulators (from whom they could extract subsequent concessions once their commitment was detailed).

In this case study, public sector 'power' over the banks is entirely illusory, and the stable outcomes that regulators sought were achieved purely by a coincident overlap of firm incentives

and publicly desired outcomes. Such an outcome speaks, clearly, to the importance of public decision making regarding the structure of firms and their operations (cf. Newman and Posner, 2011), because that structure has such clear implications for the subsequent execution of policy goals and the capacity of domestic authorities to shape the private undertakings that determine whether those policy goals are met. The case that Epstein analyses begs the question: given their potentially negative effects on subsequent public efforts to regulate them, and the variety of domestic policy goals that they are implicated in contributed to, why are cross-national financial institutions allowed to develop in the first place (cf. Goyer and Valdivielso, 2014; Epstein, 2014a)? What forces and mechanisms drive the emergence of cross-border financial markets and firms?

The purpose of this discussion is not to disprove or disavow the findings of these many well-established accounts of the politics driving integration (or protectionism) in global finance. The chapter proposes the straightforward analytical point that, with very few exceptions, the potential impacts of global financial market integration on public power are not *also* considered to be the causes of specific policy outcomes with regards to that integration. Where regulators *sui generis* preferences are salient – as in the empirical chapters below – these existing studies are unable to provide explanatory guidance.

### **Systemic explanations for public actors' choices**

As was discussed above, international capital mobility is often presented as a constraint on the policy choices that are open to domestic policymakers. Indeed, the mobility of capital has been modelled as a structural component of the international system, similar causally to the role of anarchy in neorealist IR theory (Andrews 1994, Webb 1995). The impacts of domestic policy

decisions and the opportunity costs of autarky are given by this structure. Scholars working from a Marxist-materialist ontology have also been inclined to see mobile capital as a coercive structure, one that generates hegemonic pressures to adapt and converge (Gill and Law, 1989).

Several well-known studies have analysed the role of powerful states in generating the pressures for integration. In particular, scholarly work in the realist tradition in IPE points to statist reasons for the emergence of an integrated international economic system. Where a hegemon has an (exogenous) interest in global openness, it is able to build that regime and enforce it – short of gunboat diplomacy – through its influence on the preferences of others states, as discussed in the previous chapter. This is because the hegemon’s market power allows it to have an impact on global prices, wherein the opportunity costs of remaining outside the regime become intolerable for smaller states (Hirschman, 1945; Krasner, 1976; Lake and James, 1989). While there is debate about whether the hegemonic power may use its influence over global outcomes to promote an integrated or closed system (Gowa and Mansfield, 1993), the implication is clear – one state (or a small group of states) leads, and the preferences of others regarding their integration into the global economy follow a subsequent economic logic under which it is less costly for foreign market authorities to join that system than to pursue autarky.

In the financial markets, Heilleiner’s (1994) seminal explanation for the emergence of a post-Bretton Woods regime marked by mobile capital is similar in that it positions states, and particularly powerful states as the drivers of global financial integration, and also posits an opportunity cost logic behind most states’ decision to integrate. The US, as a hegemon, led the push for capital mobility, but the UK, even though on a downward trajectory, and Japan, an ascendant hegemonic actor, also propelled action on liberalization in order to consolidate their markets’ leading positions as financial centres.

Helleiner proposes a cost-based explanation for the subsequent bandwagoning seen in global financial liberalization and integration. Powerful states ushered in the liberalization process by encouraging the formation of the Euromarket offshore in the 1960s and 1970s (cf. Goodman and Pauly, 1993), which changed the material conditions under which domestic policymakers made decisions going forward. A regulatory competition effect then took hold, due to the particular (and suboptimal) collective action dynamics in finance that made liberalization increasingly-rational for all states to pursue, due to the rising opportunity costs of remaining outside the regime. Unlike trade, actors' utility functions are not interdependent in capital markets – only one actor need liberalize its economy in order to consume the benefits of increased transactions (in this case, transactions in the growing offshore private equity markets), benefits that take the form of increased FDI, capital assets, and thus growth. Indeed, there is an argument to be made that a sole or early mover on liberalization enjoys a significant advantage, as limitations on FDI mobility increase the amount of FDI into those few liberal economies. This is Heilleiner's point when he argues that the collective action problems are mirror images of each other in trade and finance – for trade, only one state need defect for liberalization to fail, but in finance the collective action dilemma is not in the pursuit of liberalization but in avoiding liberalization, i.e., preventing any one actor from reaping the rewards of defecting and liberalization. Once one actor has liberalized, there are clearly incentives for other actors to liberalize and keep up (cf. Elkins et al., 2006 – whereby a first mover on a BIT changes the calculus for everyone else).

Through this realist and statist lens, echoed by Krazner (1977) and Drezner (2007), the power and preferences of some key state actors are taken into account and identified as having an initial causal role in shaping the degree of market integration in a particular product market or

sector. However, this approach does not fully allow for an independent role for state policymakers in making integration decisions. First, the capacity for autonomous influence is imbalanced across the international system and is a privilege exercised by only a few policymakers. Indeed, once capital markets are liberalized by some, the opportunity costs of staying outside the system are too great to avoid – hardly presenting subsequent policymakers with an autonomous, up-down decision-point (Haggard and Maxfield, 1996). In this way the causal arrow emanates more from the power dynamics contained within the international system of states rather than any state policymakers' independent preferences (Andrews, 1994). Second, the source of the powerful-state preferences is underdetermined and frequently exogenous. In Helleiner's (1994) account private sector transactions (such as the Eurodollar markets) play a significant role in influencing and then structuring public decision-making and regulatory choices. Krasner makes this underlying societal and interest group explanation clear, as he notes that the 'external power' of the US state only explains the systemic application of its power, not the domestic sources of the policy choices it makes – which are explained by domestic state 'weakness' in the face of organized social groups (Krasner, 1977).

Furthermore, Helleiner notes that while the process of capital liberalization took place through diplomatic channels and the application of coercive power, it also took place through the top-down and conditional policies disseminated by international organizations like the IMF and World Bank – another systemic pressure on the autonomous decision making of state actors. The independent power of the international financial institutions in advocating for, tying their choice of development or funding projects to, and then locking in regulations and rules that encourage global integration is well established (Nooruddin and Simmons, 2006; Goldstein et al., 2007; Stone, 2008), as is the ability of those supranational power centres to become divorced

from the interests of states on a strict principal-agent basis (Barnett and Finnemore, 1999). Furthermore, the relationship between large global producers of financial services and the IFIs has also been established, leading to a complex picture of the public and private sources of ‘conditionality’ clauses in international financial policymaking that have historically increased the pressure to liberalize rules around capital and investment – a picture that accords both international organizations and private supranational interests a considerable role in determining state policymaking outputs.

Many scholars, including Helleiner (1994) and Chwieroth and Sinclair (2013), also note the important constitutive effect of ideas on policymakers, particularly an emerging neoliberal consensus that emerged in the wake of the 1970s oil crisis, the insolvency and unproductivity of the European welfare states, and the resultant search for new ideas about how structural economic policy challenges ought to be navigated (McNamara, 1998; Blyth, 2002; Abdelal, 2007; Chwieroth and Sinclair, 2013). Echoing Haas, Helleiner argues that the emergence of an epistemic community of central bankers and economists in international organizations were able to deploy neo-classical economic ideas to help coordinate action and encourage the adoption of a neoliberal policy template across states with diverse interests (cf. Ruggie, 1982). The emergence of this epistemic community is demonstrated to be causally significant by its relative absence in the trading sphere, leading to different liberalization results in trade and finance.

More generally, the power of international organizations and the causal significance of ideas circulating through transnational epistemic communities are both important sources of pressure upon domestic decision-makers, and point to the constraints that those policymakers operate under. However, it is precisely these and the other systemic forces noted here – including the coercive preferences of leading states, the structural effects of capital mobility, and

the efforts of global actors with substantial material and normative resources – that argue for an approach to integration that takes stock of how domestic policymakers attempt to shore up their autonomy and capacity to resist external pressures. These transnational or systemic constraints on domestic policymaking autonomy are real and they augur poorly for state actors' capacity to avoid integration – but where those domestic actors have an interest in avoiding integration and, more importantly, prove that they are able to prevent it, these systemic explanations are clearly not up to the task of either analysing or explaining public decision-making regarding integration, which ought to be uni-directional (towards integration) except where large states and the ideas and international organizations that support them push against it.

### **Domestic explanations for public actors' choices**

On top of these systemic explanations, there are a host of mechanisms within the domestic system that explain why political and regulatory authorities may support greater or lesser degrees of financial market integration. As is the case with the systemic explanations just discussed, these domestic explanations generally fail to position the independent preferences of public authorities in a causal role, except inasmuch as their power is theorized generally to be far lesser than that of private financial interests (i.e., due to capture).

**Societal interests.** International integration is often a function of societal preferences for some degree of openness. Integration outcomes have been modelled in the Open Economy Politics (OEP) approach in International Political Economy (IPE), particularly through a preference aggregation process that follows a linear sequence: domestic interest groups have preferences, organize more or less effectively to press their agenda, and use the avenues afforded by institutional designs to do so (see the next section) (Lake, 2009). Indeed, the conventional

approach in OEP is analytically similar to that in Liberal International Relations theory. Firm preferences are largely derived from the position of the firm in both the domestic and global economies (Frieden, 1991; Moravcsik, 1997), and the political preferences and coalitions that firms pursue will be endogenous to policies that determine the mobility of factors and the prices of inputs – capital and labour – into the productive process (Hiscox, 2001). In this perspective firm preferences over policy outputs, such as the monetary regime or trade negotiations, are a function of the relative scarcity of its productive inputs, its vulnerability to adjustment costs or external shocks, and/or its status quo productivity and competitiveness. The extent to which firms are able to organize and jointly influence public policy is determined by several factors including their geographic concentration, particularly in electoral districts, their degree of existing coordination, and the distribution of costs that will result from particular policy decisions– where those costs will be borne by a concentrated constituency they will have an organization advantage over more disparate parties positioned to benefit from the policy change (Olson, 1965).

Once markets have been integrated to some degree – and the costs of transacting on a cross border basis have “exogenously eased” – then the winners and losers of that existing level of integration are likely to establish policy positions and advocate for the subsequent deepening or lessening of market openness. IPE and CPE scholars have thus observed a feedback loop between the deregulation of capital flows and the evolving preferences of financial service firms, similar to a "second image reversed" causal arrow (Gourevitch, 1978; Milner, 1988; Rogowski, 1989; Frieden, 1991; Frieden and Rogowski, 1996; Keohane and Milner, 1996) – and some scholars have criticized the OEP approach for failing to account for this endogeneity of domestic interests under existing levels of economic integration (Lake, 2009; Oatley, 2011). In this

dynamic an integrated global system changes the constellation of interests at the domestic level, and empowers those ‘winning’ firms who are internationally active and positioned to profit from further internationalization, i.e., groups likely to prefer ever further integration and an acceleration of the opening process (Goodman and Pauly, 1993). Indeed, empirically, as the deregulation of financial transactions and the internationalization of capital markets has increased, the interests and incentives of financial service firms has changed in kind. In many cases international market actors with interests in deeper integration form networks, trade associations, and other avenues through which they apply pressure on domestic policymakers on multiple fronts (Farrell and Newman, 2014a).

Mugge (2006, 2009) thus argues that changing preferences on the part of major European financial service firms are a driving force giving momentum to ever-deeper European capital market integration. Intra-European interest group cleavages were historically national, and incumbent domestic firms sought protection from foreign competitors through their national governments, who thus stymied deep integration under the partially-successful Investment Services Directive. As piecemeal steps towards integration proceeded through the 2000s, however, and many large firms moved into the growing European market space, this cleavage – and the inter-state protectionist politics it had given rise to – changed. State-state cleavages gave way to competition between firms on the basis of their business models, with, for example, large cross-border German banks opposing the protectionist impulses of small German banks but agreeing with similarly-structured large cross-border French banks. This coalition of like-minded European financial interests pushed the benefits of competition and access and managed to convince some of their smaller counterparts, as well as officials in small capital markets like Frankfurt and Paris who sought to siphon business activity away from the City of London.

A similar logic can be observed in the City of London, which lobbies both privately through associations and publicly through the City Corporation to advocate for the interests of the UK financial sector, but does so frequently on behalf of large, globally-operating financial service firms rather than British banks in particular (Talani, 2011; Morgan, 2012). The British Bankers Association similarly advocates for the interests of global wholesale banking and securities dealing firms with UK operations. Finally, Woll notes that many business leaders have generated momentum for liberalization out of a fear of the opportunity costs of inaction and non-participation in globalization (Woll, 2008) – acting on the belief in liberalization rather than a clear bottom-line driven logic of accumulation. The transformation of many business elites into transnational market liberalizers seeking to reduce transaction costs, rather than protectionists seeking to avoid adjustment costs, is an important structural implication of some initial set of deregulatory and/or liberalizing policy moves, with a clear sequential logic (Fioretos, 2001).

As was also noted above, this discussion further illustrates how the emergence of an integrated global economy creates and reinforces its own private financial service constituency with an interest in maintaining and even deepening integration –which can certainly make it harder for public officials to make independent decisions about the appropriate scale, depth, and pace of integration.

A related social interest based explanation for the public sector choice to integrate financial markets is the phenomenon of regulatory capture in global finance (Stigler, 1971). The outputs of public regulatory bodies may systematically favour large producers of financial services, for a number of reasons – including informational advantages that privilege practitioners, regulatory complexity that favours insiders, the effective organization of producers and their lobbying activities relative to diffuse constituencies, and even normative/ideational

framing effects (Rosenbluth and Schaap, 2003; Hardy, 2006; Woll 2014). This relationship is not limited to the domestic space, as Tsingou (2003) elaborates how private interests developed their authority and legitimacy using these asymmetrical resources during discussions about the regulation of OTC derivatives in the Group of 30. Hertig's (2012) analysis of the European regulatory response to the financial crisis notes that even where regulators have an opening and opportunity to reregulate in the public interest, the uncertainty and imperfect information that clouds the policymaking environment provides opportunities for lobbyists and industry specialists to define the terms of the debate. In particular, uncertainty exists about a) the technical operation of the marketplace, b) the alternatives to the status quo that are feasible and available, and c) the impacts of the various alternatives. This context enables private interests to define the tradeoffs at stake in a policy decision in a manner that increases their chances of gaining rents in the subsequent system (see also Pagliari and Young, 2014). Again, all of these dynamics are underpinned by the well-documented organizational and collective action advantages that producers have over consumers (Olson, 1965; Stigler, 1971).

These perspectives points to business power as a societal determinant of integration decisions. It is worth noting an alternative societal basis of pressure on policymakers in the small “economic patriotism” literature, which has identified the ways in which global integration can make it problematic for domestic authorities to pursue various domestic and democratic political imperatives – for instance around employment, social justice, and public health (Clift and Woll, 2012). The economic patriotism literature thus explains the *ex post* management by state actors of the tensions arising from a democratic domestic space co-existing with integrated global economy, where political authority over markets is largely retained within the domestic confines of the territorial state, and cross border integration is incremental and partial. The

approach is helpful because it is largely agnostic about the precise source of the pressures upon policymakers to pursue their domestic distributional goals – although those pressures are largely presumed to emanate from the institutions of democratic governance and public sentiments about integration. The broad question these scholars ask is, given some level of integration, how are subsequent decisions about further integration managed, especially in the context of domestic distributional pressures? The answers show that where there are a variety of domestic policy challenges as a result of partial integration, including lost jobs, lost influence, and lost revenues, there are also a variety of responses to those pressures.

However, with the exception of Callaghan and Lagneau-Ymonet (2012, addressed below), the explanations proposed in economic patriotism approach do not offer clear predictions about the direction and scale of the public backlash to global integration and thus the likely trajectory of subsequent integration choices – they simply demonstrate that distributional demands emanating within the domestic political space may, under certain circumstances, be prioritized by officials over the various pressures of international economic integration. Clift and Woll (2012) outline a series of mechanisms that policymakers may use to be “economic patriots” but do not broadly theorize when or under what conditions those patriotic, domestically-oriented actions are more or less likely. As an analytical starting point this is promising and indeed motivates this research project– and this thesis fits neatly within the ‘economic patriotism’ category by tracing examples of domestic management of global economic flows for domestic purposes. The economic nationalism/patriotism approach provides a bundle of analytical frameworks and explanations that explain micro-level approaches to regulation and public policymaking in particular cases. However, to adequately explain comparative policymaking episodes regarding integration, a novel theory-building effort is

necessary, as the economic nationalist approaches do not offer enough by way of precise predictions about the content of the nationalist response to integration, or about how economic nationalism influences integration decisions at the front end of the process.

Indeed, all of the approaches noted here are only able to explain the degree of international economic integration where a) there are clear social preferences over that integration, b) those social actors can be demonstrated to have access and power over decision-makers, and c) outcomes align with their preferences. Where the preferences of groups are unclear or there is reason to infer that their influence over the decision-making process is minimal, it is also reasonable to infer that autonomous decision-making by public officials – i.e., on their own account and following their own preferences – may be a significant causal factor that determines outcomes.

**Domestic institutions.** As just noted, the preferences of major domestic interest groups translate into policy outputs more efficiently when there is an institutional configuration in place that enables those groups to gain access to and exert leverage over domestic policymakers. For instance, institutional factors such as the nature of the electoral system (Mansfield and Busch, 1995; Grossman and Helpman, 2004) and the number of veto players or access points to public actors (Tsebelis, 2002; Mansfield et al., 2007; Ehrlich, 2011) determine whether public actors are open to private influence – and hence the extent to which private preferences regarding the integration or protection of a sector or segment of producers are reflected in policy decisions. Institutional design may significantly determine the policies that national officials deem it rational to pursue, and can substantially undercut the degree to which those officials choose and then pursue policies with the “national interest” in mind rather than the preferences of more narrow rent-seeking interests (Krasner, 1977; Katzenstein, 1978). Studies making use of this

institutional logic describe greater or lesser degrees of regulatory insulation or openness, and firm preferences are often treated as comparative statics – i.e., as inputs into the policy process with greater or lesser degrees of influence over outcomes (although see Krasner, 1977; Henisz and Mansfield 2006).

The institutional basis of production and investment patterns highlighted in the Varieties of Capitalism (VOC) literature foregrounds an important, additional point: employers' preferences for economic integration are not simply derived from the relative and changing prices of the inputs into their production processes and then aggregated through institutions, but are also derived from the broader institutional framework within which employers are embedded (Hall and Soskice, 2001). Where integration poses a threat to the sunk costs that employers have invested in a given business strategy – as well as complementary institutions such as wage bargaining or vocational training institutions – then those producers are likely to seek outcomes that protect their investments, including outcomes short of the economic integration of their sectors (Berger and Dore, 1996; Culpepper, 2005; Fioretos, 2011).

The significance of these institutional approaches is that they outline how and why societal preferences are aggregated into particular outcomes and, in the case of the VOC, they are also able to precisely identify the basis for those societal preferences – i.e., they are derived from more than simply a firm's ledger or balance sheet. In identifying these important causal variables, institutional approaches simultaneously describe greater or lesser degrees of autonomy for state actors in making integration decisions. In OEP, where firm influence is high it is likely that, as a corollary, public officials' autonomy over integration decisions is compromised. In the VOC-framed approach, it is not always clear whether state actors and institutions have an

independent causal role at all (with exceptions, for instance – Lutz, 2011; Fioretos, 2011; Culpepper and Reinke, 2014).

It is certainly the case that the preferences of large producer groups frequently determine how financial markets are regulated and the degree to which those markets are integrated on a cross-border basis. In such circumstances public sector decision-making regarding integration is heavily circumscribed, either via societal pressure that is mediated through institutions, or by the stickiness of economic institutions due to private incentives to protect existing comparative advantages and resist change (Thelen and Mahoney, 2009). Institutions can empower societal interests at the expense of state policymakers' autonomy and their capacity to be policy-seekers – that is, policymakers' capacity to make choices and undertake reforms without being forced to internalize the distributed costs of their policy efforts.

But it is worth noting that policymakers may also be empowered to make autonomous decisions by a given institutional environment, and in that way may be empowered to be independent policy-seekers and thus pursue their conception of the “best” public policy choice demanded by a given policy challenge. On a broad level, policymakers will be empowered vis-à-vis societal interests if they are isolated from them, that is if they operate at an arms-length from officials with office-seeking incentives that make them more readily open to the influence of interest groups – i.e., the agency model of policymaking. Certain electoral or legislative arrangements may also be more given to this kind of autonomous policymaking.

Moreover, certain institutional configurations have been shown to increase policymakers' ability to shape private undertakings and steer private activity towards broader social goals, either by giving them levers over the allocation of credit or resources to coordinate a broad swath

of private activity towards desired productive investment and activity (Johnson, 1982; Hall, 1986; Evans, 1995; Hall and Soskice, 2001).

Furthermore, the institutional environment within which policies governing the market are made may itself be variable, even within a single jurisdiction at a single juncture. An important recent contribution from Culpepper (2011) suggests that different “governance spaces” (each with its own institutional dynamics) will be activated and relevant depending on the salience of the issue at hand. In some issue areas an interest group-vs.-interest group dynamic will play out in a partisan manner, with parties on the left and right trying to form winning coalitions from employer groups and voters; but other issue areas – particularly complex, technical, and low-salience issues such as many of the agenda items in financial market governance – will be decided within bureaucratic networks, wherein private groups may or may not have both access and persuasive arguments that counter the ideas and preferences already contained within the professional bureaucracy. In such circumstances, decisions about financial market governance are certainly better understood if focus is cast upon the preferences and incentives of bureaucratic actors such as regulators and senior officials, with those actors being analyzed as independent and empowered interest groups in their own right. That is an analytical strategy that has only very infrequently been deployed in scholarship that focuses on the integration of market economies, but Culpepper’s framework pushes us to consider where and when such a strategy may be appropriate.

### **Explanations for takeover and corporate governance outcomes**

A final set of explanations for the extent of integration in the financial service sector can be found in the literature on the political economy of corporate takeovers and the market for

corporate control – explanations that focus at a much more micro-level on the frameworks that govern firm-level integration.

It is evident that market integration is often a function of market rules, and so firm-level mergers and acquisitions that lead to multinational firms are by no means the sole determinants of the overall level of integration across markets. A multinational corporation may follow a multiple home markets model, or a branch-plant model that does not meaningfully result in an internationalization of production, transacting, or management; conversely, a multinational corporation may implement measures to streamline its production, service-delivery, and backroom support structures on a cross-border basis, in ways that result in cross-border transacting by both the firm and its customers/consumers. Furthermore, where existing national rules preclude such cross-border synergies and activities, firms with operations in multiple environments are likely candidates to lobby for reduced transaction costs through the increased harmonization of rules and the liberalization of flows across borders (cf. Frieden, 1991; Mugge, 2006). As a result, it is worth looking to the rules that govern takeovers and mergers at the firm level, because those rules can clearly have an impact on the emergence of multinational firms, and thus the degree to which those multinational firms and the multiple markets that they operate in are subsequently integrated.

There is a small but well-developed literature in political science that looks at the provenance and impact of corporate governance rules, and the manner in which those rules vary across jurisdictions. Corporate governance itself is a host of mechanisms, institutions, and processes that allocate property rights, decision-making powers, and procedural duties to the various stakeholders in a public corporation. In general, corporate governance rules provide mechanisms for some empowered stakeholders to hold corporate managers to account – whether

those stakeholders are employees, diffuse shareholders, large blockholders, public officials, or some combination thereof. A major accountability mechanism (particularly in liberal market systems) is the takeover, including the hostile takeover, which is theorized to solve moral hazard and principal-agent problems within the business firm (Callaghan and Hopner, 2005). This is a means by which ineffective and/or inefficient corporate management is held to account through the loss of independence and, as is likely, the significant loss of prestige and remuneration as it is replaced by a more efficient and effective management team able to generate greater value for stakeholders (whether that ‘value’ is defined as dividends or some other payout). It is notable in this context that hostile takeovers are not allowed and/or deployed to the same degree across jurisdictions, which reflects the preferences of the different stakeholders that are empowered across different capitalist systems (Goyer, 2011).

The political economy of corporate governance has thus focused on how different allocations of property rights and privileges with regards to the public firm are the result of – and therefore empower – the political activities of different coalitions of social groups, including major financial service firms such as asset managers, securities dealers and investment firms; as well as more diffuse groups such as pension-holders and employees/labour (with frequent overlaps between those groups) (Roe, 2003; Gourevitch and Shinn, 2005; Cioffi, 2006, 2010). These preferences for different systems of corporate governance are refracted through political institutions, including electoral systems and political parties, which lead to and empower certain coalitions and their preferences over others, and give rise to distinct systems of rules and laws governing public firms. Of course, these rules and laws are also embedded in historical and cultural factors such as national legal systems, the degree of state involvement in the economy, the development of institutional complementarities, and the expectations of various stakeholders

regarding the appropriate oversight of private business activity; crises and scandals of corporate governance may also play a significant, galvanizing role in driving coalition-building efforts (Cioffi, 2010). In sum, these dominant approaches to corporate governance rules across jurisdictions are logically and analytically similar to the OEP model, in which social preferences are mediated through institutions (including but not limited to political institutions) to generate some set of distributional outcomes that are crystallized in corporate governance rules.

A second approach to explaining takeover rules can be found within, or as a subset of the VOC literature, in which corporate governance rules are part of larger system of institutional complementarities that result in “insider” forms of stakeholder governance in some economies and “outsider” forms of largely diffuse shareholder governance in others (Dore, 2000). Those rules are designed to protect existing comparative advantages, for instance by protecting incumbent managers in order to promote long-term research and growth strategies in coordinated systems, or exposing those managers to the threat of hostile takeover in order to promote innovation and rapid returns in liberal systems (Hall and Soskice, 2001). Scholars influenced by the VOC note that takeover rules are supported by coalitions of employers, private stakeholders, and labour groups with sunk costs in existing institutional designs, but also note that large employers in coordinated economies may have incentives to alter or even loosen restrictions on hostile takeovers as they become more globally active.

This shift in production models may render employers more inclined to their swallow sunk costs in existing institutions if it means greater access to foreign capital and investment (Culpepper, 2005). In addition, in “insider” or coordinated corporate governance systems, the various stakeholders of large corporate entities (their business partners, large shareholders, and employees) have been theorized to be opposed to corporate takeovers by foreigners because

those takeovers undo existing residual network-based mechanisms of coordination – and politicians are theorized to be opposed to foreign takeovers as a result of their incentives to be responsive to those domestic shareholders (Hellwig, 2000). As the incentives of stakeholders to protect those networks declines (as a result of previous rounds of integration, for instance), however, the inevitable political backlash to foreign corporate takeovers declines as well, suggesting a secular decline in the stakeholder demand for protection and the political response to it (Callaghan, 2014). In these studies, it is an institutional equilibrium that determines the rationality of certain rules governing takeovers and the incentives of stakeholders to invest in activities that maintain those rules; while societal preferences for institutional change may give rise to altered or wholly-new corporate governance rules, any independent role for state actors remains very much circumscribed by societal preferences. Indeed, Culpepper has recently argued that takeover rules are almost entirely a function of the access and lobbying power of private interests engaged in “quiet politics” and thus capturing the rulemaking process (2011).

Finally, in a study beyond political science, Dinc and Erel (2013) find that the most efficient explanations for displays of “economic nationalism” in cross-border takeovers (which includes interference as well as blocking takeovers at the expense of foreign counterparties) can be found in “societal preferences for natives against foreigners”, measured by the vote-share for far right-wing political parties and by survey evidence. These nationalist and nativist ideological preferences aggregate from the societal to the policy level and inform the political decision to act against foreign takeovers in the corporate sector. In Dinc and Erel, as in the approaches elaborated above, the state’s approach to takeovers is largely determined by the constellation of societal preferences regarding those rules and the outcomes they shape.

## **Explanations based on the independent preferences of public actors**

There are a small number of perspectives that examine the emergence of cross-border product markets and multinational corporations not as a result of societal or systemic pressures acting on policymakers, but as a result of independent public decision-making made within the context of the goals that policymakers are trying to achieve. The following approaches are important in that they explain integration as an outcome that is shaped by relatively insulated policymakers, who either pursue it or block it for their own discrete policy-seeking reasons (i.e., substantially free from domestic or international pressures). While these explanations are ultimately unable to explain exchange merger outcomes, they are important to flag as broadly similar to the analytical approach adopted in this dissertation, in that they see the impacts of integration on state authorities' broader policymaking capacity as a significant explanation for the level of integration that those authorities prefer or pursue. Many of these inferences underpin the theory of regulator dependence that follows.

There are several studies that emphasize the state's and public actors' causal role in decision-making relating to corporate takeovers in particular.

Tiberghien (2007) looks to the state to explain change. He analyses how coordinated market economies respond to a common external incentive: capital-rich fund managers and institutional investors that offer the promise of investment in return for transparency-oriented reforms to corporate governance and corporate structure rules, and related areas. Unlike the VOC approaches discussed above, which emphasize institutional equilibria reinforced by firms' investment patterns, Tiberghien finds a critically important causal role for senior policy elites, or "entrepreneurs", who navigate institutions and, where state institutions afford them the needed autonomy, attempt to build policy coalitions around these processes of regulatory and

institutional change: “unlike the VOC approach, [the book] argues that political and state institutions play a large and active role” (2007, xiv). Where state actors share a preference for policy changes that bring capital and investment into the domestic economy, although they are differently enabled or constrained by statist institutions regarding the degree and content of the reforms they can pursue.

Conversely, Callaghan and Hopner (2005) look to the state to explain continuity. They examine the distribution of votes on harmonized European takeover rules, and find that “due to different national starting points, the benefits and costs of a unified market for corporate control are distributed unevenly across EU member states.” Member states vote in a manner befitting their “national starting point”. As a result, national preferences regarding the Takeover Directive follow from the logic of a “clash of capitalisms” – that is, the votes show a conflict between coordinated and liberal capitalist models and demonstrate the incentives that each states’ authorities have to promote European rules that protect the sunk costs and comparative advantages of their domestic constituents. Importantly, they find that this explanation trumps a partisan explanation based on class conflict, which predicts that the distributional implications inside the business firms of different corporate governance rules, “by securing benefits for shareholders at the expense of employees”, should explain outcomes. This suggests that on takeover rules, Member State officials are voting to protect the value of (i.e., the public goods generated by) their domestic institutions, rather than voting in order to protect any particular social group from adjustment costs.

Goyer and Valdivielso del Real (2014) assess how takeover rules that differ across two market economies, France and Germany, can give rise to functionally equivalent outcomes, namely the very low level of foreign penetration of the French and German banking sectors.

They determine that institutions that are designed quite differently, including corporate governance provisions regarding the powers of boards and shareholders, can be deployed to similar ends by stakeholders determined to impede foreign takeovers of domestic financial institutions. In the French case in particular, the authors identify the critical role of the state in driving concentration in the French banking sector, because it holds a veto over foreign takeovers in banking and insurance. However, the state preference for a nationally-owned banking sector is not interrogated in this article, and it is assumed non-problematically in the article introducing the same volume on banking ownership (Esptein 2014a). While it is not a surprising finding that Paris officials have interfered in the market for corporate control of the French banking sector, it is worth wondering why, then, they did not do the same regarding the Parisian stock exchange. Their preferences are not explained

On this, Callaghan and Lagneau-Ymonet (2012) look to the state to understand a single decision-point: the lack of official French interference in the foreign takeover of its stock exchange. They find that the discursive resources of leading societal actors – namely, whether their “economically patriotic” claims to be motivated by the public or national interest are persuasive and deemed legitimate, and whether those claims can be mobilized to find “patriotic” alternatives – shaped the French government’s approach to the treatment of the NYSE takeover of Paris-based Euronext in 2006-2007. In particular, those societal actors’ lack of discursive resources, plus the relative lack of electoral and public mobilization on the issue, meant that the French government and the markets regulator were free to pursue their preferred strategy, which was to promote the competitiveness of the Parisian market by taking a hands-off approach to (and even tacitly encouraging) the tie-up between New York and Paris. Callaghan and Lagneau-Ymonet thus specify conditions under which policymakers will be more or less able to pursue an

independent set of preferences regarding a takeover of a key piece of financial market infrastructure. However, the authors' framework cannot explain why French policymakers were unconcerned about a merger where other authorities have stepped in to act. Explaining independence and insulation are important, but a full causal explanation of any decision also demands an understanding of what the authorities do under those insulated circumstances, and why – i.e., why they want what they want.

Lastly, Thatcher (2014) has recently analysed the EU's competition regime to draw out the ideological and policy objectives that drive the European Commission's decision-making on cross-border mergers within Europe. In doing so he looks carefully at the preferences of public officials regarding the liberalization and re-regulation of various product markets in Europe. In this way, Thatcher's study recalls previous work on service sector re-regulation across OECD states that takes seriously the independent and often ideologically-driven preferences of politicians and, regulatory officials in building competitive markets in the often-statist and often-monopolistic telecoms, transportation, and financial service sectors (Derthick and Quirk, 1985; Vogel, 1996; Thatcher, 1999). In particular, Thatcher (2014) develops an explanation for merger outcomes that differentiates between firm-level integration that is consistent with broader EU policy objectives, and firm-level integration that works against those objectives and as a result is blocked on competition grounds. His medium-n results indicate that the Commission does not simply pursue a pro-competition policy predicated on neo-classical economics and the pursuit of ideal-type market structures. Rather, "the Commission pursues an 'integrationist merger policy' whereby it both applies competition criteria and also allows the development of larger European [firms] to enhance economic integration" (2014, p. 3). This suggests that cross-border integration of European firms may often complement or reinforce the broader Single Market-

building activities that the Commission is also tasked with implementing, even if the competition directorate is meant to apply a purely technical and apolitical analysis in its merger review. Firm-level integration can therefore augment the capacity of European officials to develop the Single Market for various products and services. This finding is important and discussed again in the relevant case analysis, below. But it is important to consider that the goals that the Commission is pursuing in its integration decision-making are by their very definition already “international” in nature, as the Commission is a supranational entity with a cross-border market-building mandate. As Chapter 7 of this thesis demonstrates, it is necessary to consider the interaction between the supranational policy goals of the EU and the domestic policy goals of Member States, the latter of which may or may not align neatly with those of the Commission, and which must be considered in the context of the Commission’s independence to pursue its own policy objections (Putnam, 1988; Moravscik, 1997). Only such an analysis can render a full explanation not just of process but also the sources of policymakers’ preferences during discrete exercises of EU competition authority.

Beyond the narrow realm of takeover and corporate governance rules, there are broader perspectives on financial market governance that consider the independent preferences of state officials in determining the extent to which markets and firms are internationally integrated. Mercantilists and scholars of development and dependency have long noted the value of retaining national control over the financial sector (cf. Epstein, 2014a); some more contemporary arguments have noted, conversely, that national purposes might be actually well-served by international markets and firms.

For instance, at the same time that economic interdependence was being identified by leading scholars as a potential constraint and source of complexity for unilateral state action

(Keohane and Nye, 1977), others saw in the growth of global trade, multinational firms and cross-border production the potential for officials from powerful states to export their regime preferences abroad through that integrated system (cf. Hirschman, 1945; Nye, 1974; Krasner, 1976). Gilpin (1975, 1976) in particular looked at the multinational US corporation as a potential ambassador and enabler of American preferences for a liberal regime governing global trade and production (cf. Nye, 1974, pp. 157-161). This neo-mercantilist approach noted the potential synergies between the expansion of US market actors and the expanding reach of US policy preferences as, “generally, in the relationships between American business and government the activities of the corporate are seen by public officials to advance the larger security and economic interest of the nation” (Gilpin, 1976, p. 190). It is notable that for Gilpin, the relationship between public and private American interests in the global economy is initially complementary but in no way monotonic: the positive impact of American foreign investment has the potential to decline over time and erode US comparative advantages, for a host of reasons. One compelling reason is foreign national interests’ increasing influence over the private undertakings of American MNCs. Gilpin’s approach therefore identifies circumstances where national goals are not met by the spread of multinational firms, and he predicts a highly-plausible long-term political reaction to those circumstances. For instance, Gilpin writes,

[As] American foreign investment is increasingly forced to serve the interests of other nation-states, one will witness a reassessment of American public and official attitudes about the MNC’s usefulness to the US. As Americans become more concerned over high employment, inflation, industry, there will be increased pressures to restrict the outflow of American capital and technology. More and more groups will join American organized

labor in challenging the thesis that what is good for Exxon and IBM is good for the country. The issue of the multinational corporation will become increasingly politicized both domestically and internationally. (1976, p. 191)

Gilpin usefully identifies a major reason why officials (particularly American officials) might be initially keen to encourage the growth of MNCs, but, importantly, he also follows earlier mercantilist scholars to make a clear case for the long-term retention of domestic control over financial services (Gerschenkron, 1962; cf. Krasner, 1985; Epstein, 2014a). However, while at a high-level his insights are compatible with the approach here, the neo-mercantilist lens adopted by Gilpin and his mercantilist predecessors is both outdated and unable to predict a) the nature and content of the political backlash to an increasingly ‘politicized’ MNC, b) the impacts of that political backlash, and c) the way in which these negative long-term effects may influence ex ante decision-making about market integration. Gilpin’s study and the broader mercantilist mindset provides a call-to-arms for policymakers to revisit their assumptions about the utility of the MNC model, rather than a theory of various ways in which the internationalization of firms and production is shaped by public authorities.

Abdelal (2007) explains the emergence of international capital mobility by reference to the independent policymaking preferences of “unlikely” state actors in Europe. He does so by, first, questioning the American (and Wall St.) dominance in most mainstream accounts and, second, pointing to substantial European and particular French influence in the development of a liberal global regime for capital. In Abdelal’s account, French policymakers chose financial market integration as a way to introduce innovation into the economy, free up credit and capital for households (cf. Seabrooke, 2006) and export inflationary pressures abroad – i.e., state actors pursued liberalization for domestic (French) reasons. Abdelal gives French policymakers

considerable autonomy in developing their preference for capital liberalization as a ‘fix’ for several policy challenges in the domestic economy.

More recently, scholars have unpacked the concept of “economic nationalism” and have helpfully separated that term from its association with protectionism and autarky. In particular, studies have pointed to the reasons why nationalists might be willing to support – or even aggressively pursue – the integration of their markets and market participants into the global economy. This “liberal economic nationalism” in places such as Quebec and post-communist Europe can underpin the liberalization of domestic markets and drive their support for free trade (Helleiner, 2002; Helleiner and Pickel, 2005), i.e., where the integration of markets is believed to complement the purpose of building a distinct global role and strong material basis for the nations in question. In this sense the broader public policy objectives of nation-building and even independence may be pursued via a liberalization and integration strategy. The scope of this particular argument is quite narrow, however, and the more nationalistic elements of the integration decisions examined in this thesis are, as is shown below, epiphenomenal and emergent, and do not cause the outcomes that are observed (cf. Callaghan and Lagneau Ymonet, 2012).

Each of these accounts notes that public officials can have strong and independent preferences regarding the rules that shape corporate structure, corporate takeovers, and (more broadly) the extent of cross-border integration in the private sector; moreover, each of these accounts notes and that those independent public sector preferences can be causally significant. As is demonstrated below, however, they are unable to predict the outcomes of mergers involving financial exchange firms.

The main difficulty is that the source of official preferences is either underdeveloped or insufficiently theorized to be applied in a comparative study. State actors' preferences are tied to an invariant external mandate or imperative such as market or nation building or competitive re-regulation (Helleiner, 2002; Helleiner and Pickel., 2005; Tiberghien, 2007; Thatcher, 2014), or simply to the particular policymaking context in which their autonomy and insulation is enjoyed (Gilpin, 1976; Abdelal, 2007; Callaghan and Lagneau-Ymonet, 2012). Most of these approaches fail to provide the tools necessary for a comparative assessment of different state actors' preferences regarding takeovers and firm-level integration. The VOC-based perspective does offer a general theory of preferences that could be used for comparative study, whereby officials' preferences are derived from the type of capitalism practiced in their home market (Callaghan and Hopner, 2005; Goyer and Valdivielso del Real, 2014) – but the VOC approach is simply not able to explain the outcomes of cross-border exchange mergers, as has been discussed.

### **Towards a theory of public preferences regarding multinational corporations**

If the public sector is indeed insulated regarding its capacity to formulate and act on preferences over international firms, then what are public actors likely to want regarding such firms? This chapter concludes, here, with a final review of literature that begins to offer suggestions regarding how public officials view multinational corporations, detailing in particular the nature and sources of their preferences and concerns regarding the structure and undertakings of MNCs. These inferences are then put to work in the next chapter, which develops the theory of regulator dependence in detail.

It is worth first looking to existing analyses of the public sector's perspective on international firm activity. The relevant approaches to the multinational corporation (MNC) in

political economy tend to make use of one of two analytical strategies: either public sector variables are deployed as independent variables that explain firm-level outcomes; or MNCs' activities are the explanatory variables that determine political outcomes. Both approaches are significant here. Although they do not explicitly theorize public preferences, they invoke the preferences that public actors are likely to develop regarding MNCs – preferences over how MNCs behave and how the benefits of MNCs' international production are distributed.

The first type of study looks at the scope and activities of multinational firms as by-products of political variables such as regime type, political institutions, and public policies. Dunning's "eclectic paradigm" theorizes firm decision-making about internationalization based on "locational advantages" (1977, 1993) among other variables; more recently, Li and Resnik (2003) and Jensen (2006) have explained firms' FDI decisions as based on their preferences for certain types of political institutions – i.e., transparent and democratic systems with strong property rights – rather than the specific incentives generated by policy concessions (such as tax breaks or regulatory loosening). Pauly et al. (1999) have demonstrated that far from converging on a standard set of organizational and strategic behaviours, multinational firms retain highly differentiated structures that strongly reflect the different financing, industrial, and political attributes of their home markets, which shows that different types of capitalist systems can affect the way that firms behave abroad as well as how they organize at home (cf. Berger and Dore, 1996; Hall and Soskice, 2001). Woll (2008) argues that firms undertake their lobbying regarding international integration and their subsequent internationalization strategies in a deeply social environment, through their interactions with public actors such as regulators and trade negotiators. Through these socialization processes, incumbent and monopolistic firms can learn

to have preferences for trade liberalization that might not appear rational if simply extrapolated from their material production profiles.

It is certainly the case that firms' cross-border business activities are endogenous to regulation: their incentives to expand are not entirely reducible to the cost and opportunity structures generated by technology but are also informed by the costs and opportunity structures generated by existing market rules and political conditions (Mugge, 2006). Many of these rules-induced reasons for exchange firms to merge were discussed in Chapter 2, and the cases under examination here cannot be understood without also understanding exchange firms' incentive structures within the broader regulatory context in which they operate. Given the impacts of institutions, policies, and regulations on firm-level activity, it is reasonable to infer that public officials will have systematic preferences regarding these political supply-side variables – that is, regulators and politicians care about the incentives the public rules are generating for firms. These rules indeed provide important background conditions and populate the empirical details in the case studies that follow in this dissertation.

However, firms' responses to political structures or policy choices are not the independent variable of interest in this dissertation; it is instead focused on the political ramifications of – and political reactions to – firms' international undertakings. The theory presented in the next chapter explains the political response to financial service firms' efforts to internationalize; that is, the dissertation theorizes public preferences regarding the international integration of exchange firms.

The second approach to MNCs in political economy more closely approximates this purpose, and – given that it looks at how MNCs shape variables that public actors care about – more clearly points to public sector preferences regarding the undertakings of MNCs. In this

approach, scholars have elaborated the impacts that multinational corporations' activities have on variables with distributional and political effects, including labour and environmental protections, the economic incentives facing domestic entrepreneurs, and the accumulation and distribution of revenue and profit – which may or may not be favourable to home and host markets alike (Gilpin, 1976). On the one hand, public actors generally seek to attract foreign investment and ensure that multinational firms engage in productive activities in their jurisdictions by offering attractive incentives on the supply side; on the other hand, those multinational firms' activities can have ambivalent impacts. For instance, an MNC's decision to pursue internationalization through a vertical subsidiary or a sub-contractor may have a “spillover” effect, whereby its commercial practices and its home country's regulatory standards enter into the host market as a result of its investment and production decisions (Mosley, 2011). Perhaps not surprisingly given the inequalities present in North-South relations, substantial research effort has been focused on the activity of rich-country MNCs in less-developed countries: Lall and Streeten (1977) note the problematic host country welfare effects of MNCs, measured on three dimensions (capital and investment, firm organization, and technology spillovers) where MNCs' transmission of benefits is often intangible and may actually be negative. Fieldhouse (2000) qualifies this finding with the view that “no general theory of the MNC and its relationship with the sovereign state can be drawn up”: the relative bargaining power of host states and host state authorities will shape MNC undertakings as well as the political and economic consequences of MNC activity for the less-developed market, including the extent to which the MNC is allowed to extract monopoly rents. Fieldhouse's view is that the power resources of state actors explain the subsequent welfare impacts of international firms on that state – an important point. As a high-level inference, Fieldhouse's claim travels well from

relations between MNCs and developing country officials to relations between large financial service firms and rich country market authorities – as will be theorized in more detail in the next chapter.

The more direct impacts on policymakers that result from financial firms' international undertakings have also been examined. Watson (2007) makes an important contribution in detailing how different types of firm-level integration strategies can lead to different challenges, risks, and costs for policymakers, and given the subject of his argument, it is worth considering in some detail.

He distinguishes between two dimensions of capital mobility: spatial and functional. The liquidation of assets and their reinvestment in other vehicles is at the root of both, but there is a key difference between the two dimensions. For Watson, the spatial mobility of capital refers to the ability of capital asset-holders to move those assets across jurisdictions and political boundaries with relative ease and re-invest in similar vehicles in a different geographic location. In contrast, functional mobility refers to the fungibility of capital assets, and is related to (and may be dependent on) the liquidity of those assets. Capital takes on different forms as it is invested in different vehicles, whether that is derivatives or bonds, cash equities or properties or infrastructure. So to illustrate, spatial capital mobility refers to the divestiture of, for instance, corporate bonds in one jurisdiction and the reinvestment of that capital in corporate bonds in another jurisdiction; functionally mobile capital shifts from bonds to stocks within a single jurisdiction. Of course, as Watson notes, capital can be simultaneously mobile in both its functional and spatial dimensions; or it may be mobile across these dimensions to different degrees, depending on market and regulatory conditions, i.e., the mobility available in the

marketplace due to liquidity constraints, and across jurisdictions due to regulatory or political constraints (cf. Newman and Posner, 2011).

For the purposes of this discussion, Watson's most important contribution is his observation that different cross-border integration proposals are likely to enable these two forms of capital mobility differently: crucially, the resulting degree and type of integration will generate different market risks and therefore lead to different distributional and policy impacts. In a particularly salient chapter, Watson examines two stock exchange merger proposals from around 2000, both involving the London Stock Exchange - one a proposed merger with Deutsche boerse, and the other with OM Gruppen, which was at that time a Scandinavian technology and exchange conglomerate, since incorporated into US-based NASDAQ (2007, pp. 189-211). He argues that the two proposals had starkly different implications for market volatility and risk, and as such promised to have different impacts for market authorities charged with analysing the proposals and overseeing the resulting markets.

The DB-LSE proposal offered an increase in functional capital mobility, by linking the stock exchange in London with DB's large and liquid derivatives exchange, Eurex. It would have made it more seamless for investors in both London and Germany to convert stock-based assets into derivatives and vice-versa, thereby offering a hedge against a price change in stocks, and allowing investors to subsequently re-invest in the equities marketplace with greater confidence. Watson argues that, *ceteris paribus*, increased hedging opportunities increases investors' protection against their depreciation risk in holding stocks, which boosts market confidence and liquidity, which in turn increases the efficiency of the price-discovery process. This proposal would also have allowed for a consolidation of exchange activity on two large venues under a division of labour – the LSE would have focused activity in cash equities

(stocks), while Eurex would have concentrated on derivatives, further enhancing the efficiency of the pricing mechanisms in those two types of products. The net effect would be a reduction of asset depreciation risk for exchange users and more efficient capital and price formation processes: in short, a safer and more efficient market.

The OM proposal, by contrast, would have created a cross-border IT platform, Jiway, to which exchange members in multiple jurisdictions would have had access. This electronic portal would have highlighted differences in bid and ask prices for stocks - i.e., the 'spread' – across markets and therefore exposed short-lived arbitrage opportunities. Such a system would increase volatility by encouraging speculative and short-term investment positions. Importantly, it would also have encouraged capital to move rapidly across borders, depending on where opportunities for quick profits could be found. Moreover, OM's vision put London at the centre of this cross-border capital activity, positioning the LSE to sap activity and liquidity from other cash equity markets in a "zero-sum game". This spatial mobility of capital might have been efficient in one important way, by encouraging resource allocation where asset prices were lowest as measured by the spread (or, defined differently, where rents were highest) – but it also would have meant a loss of stability, liquidity, and pricing efficiency in markets other than London, as well as a potentially unstable concentration of stock market turnover at the LSE.

Both proposals collapsed before needing regulatory approval, and so it is not possible to assess whether the differential impact of these proposals had an impact on the preferences expressed by public authorities. However, a central component of Watson's argument – that not all infrastructure integration proposals are the same, when scrutinized for the different benefits and risks they may generate for public officials – is a key point that is elaborated in the analysis presented in this dissertation. Watson's point here is that firms' cross-border integration efforts

can lead to different kinds of policy issues. As regulators scrutinize firms' plans to internationalize, the subsequent difficulties or outcomes that international integration will lead to for public actors are key considerations.

A final perspective explicitly ties market regulators' independent policy preferences to the degree to which firms and production are internationalized. In order to explain European regulators' preferences for centralized banking supervision in the EU, Spenzherova (2014) looks to the structure of the banks being regulated. She determines that the key variable explaining regulators' preferences is the existing market structure in the banking sector, particularly the way that structure shapes banks' incentives, especially in a crisis: the degree of internationalization of domestic banks' operations and the level of foreign ownership in the domestic banking sector are thus the determining factors. There are two findings – that a low level of internationalization of domestic banks' activities and high penetration of foreign ownership leads domestic banking authorities to prefer the maintenance of their exclusive domestic supervisory authority (so that, in a crisis, they can ensure that foreign banks' liquidity and credit allocating activities are managed at home rather than in Brussels and Frankfurt); conversely high banking sector internationalization and low foreign ownership leads to the opposite preference (because regulators can be assured that their domestic banks with international activities cannot 'cut and run' from their home market in a crisis, and so they instead pursue lower transaction costs for those banks through EU-level rule convergence). The structure of banks thus determines regulators' ability to control them and ensure that they conform to key regulatory priorities such as liquidity provision and capital maintenance. This firm-level dynamic leads directly to regulatory preferences over systemic policy outcomes.

In short, these latter approaches (and Watson and Spendzherova in particular) clearly point to the impacts that international financial service firms have on many of the policy issues that market authorities care about, including the volatility and stability of markets, and the management and oversight of market risk and private capital resources. Watson does not subsequently develop a theory of policymakers' preferences, but Spendzherova does so explicitly and helpfully, explaining policymakers' preferences over the centralization of banking sector authority in the EU.

It is therefore reasonable and helpful to infer an important causal linkage between a) multinational production through MNCs, b) the policy challenges that such firm-level integration can create for market regulators, and c) the resulting preferences that market regulators have over various cross-border market issues. In the literature just cited, only Spendzherova takes the third step to theorize and then test those regulator preferences over public policy outcomes in the context of firm-level integration. The theory presented in the chapter does the same, but under a different set of conditions: given the potential impacts of MNCs on the issues that regulators care about, what preferences do regulators exhibit if the firms are not yet internationalized, i.e., MNCs are proposed but do not yet exist?

## **CHAPTER IV**

### **THE THEORY OF REGULATOR DEPENDENCE**

#### **Introduction**

The drivers of cross-border mergers and acquisitions involving exchange firms were explained in detail in Chapter 2. That chapter explained that exchanges are incentivized to merge by a collection of related supply and demand side pressures – regulatory, technological and market structure changes are all compelling exchanges to merge. In this context, cross-border mergers can be effective cost-savings and value-generating activity for exchanges, due to the potential for both economies of scale and economies of scope. Moreover, the incentive for firms to realize those economies of scale and scope can come from some combination of three sources: the fiduciary duty to maximize shareholder value and increase the profitability of the firm; the ambitions and beliefs of the firm’s managerial cadre (sometimes called the ‘empire-building’ impulse); and pressures from clients, prospective users, and even public officials.

Importantly, these private sector strategies can have significant impacts on public actors. The impact of mergers on the public sector is the focus of this theoretical chapter, which proceeds in two sections.

The first section outlines an overall theoretical approach to financial sector integration decision-making, which has three component parts. The theoretical approach first considers the predicates and significance of public sector insulation: it assesses the conditions under which policymakers can be thought of as insulated from societal pressures, and then identifies the appropriate manner of testing whether those conditions are in place. Next, the second component of the theoretical approach identifies the appropriateness of a historical

institutionalist lens in order to identify the precise nature and direction of regulators' preferences regarding integration. It argues that those preferences are embedded in historical policy decisions regarding the structure and governance of the market that is engaged in integration.

In the second section of this chapter, the causal mechanisms that underpin officials' decision-making regarding exchange integration are theorized, and a theory of regulator dependence is proposed. This section elaborates the theory's assumptions regarding market authorities' incentives to effectively execute their mandates and achieve policy goals tasked to them, which leads them to an overarching preference for policy outcomes that maintain their existing power resources. The section next proposes a cost-based mechanism through which cross-border firm integration erodes those power resources. Finally, the section theorizes the conditions under which the erosion of public power due to these costs is likely to lead to public interference in a cross-border integration proposal. These conditions are characterized by regulators' dependence on the integrating firm. The second section and the chapter conclude with the hypotheses and implications that flow from the theory.

## **The theoretical approach**

### **The insulation of public sector preferences**

This chapter presents a theory centred on regulatory preferences regarding international integration, and as such the analytical strategy of focusing on public sector actors independently of other groups is in need of theoretical justification – as well as subsequent empirical justification. When is it appropriate to consider the public sector preferences – and their deployment in policy choices – in isolation from societal interests, including voters and interest groups?

Scholarship on the relative insulation or exposure of different policymaking processes to public and societal influence offers suggestions on how to treat this issue (and some were referenced in the previous chapter). In general, it is a common approach in existing scholarship to consider that both the stability of policy as well as the direction of policy change are shaped by the degree to which public institutions give societal interest groups access to public sector “veto” or “access” points (Tsebelis, 2002; Mansfield et al., 2007; Ehrlich, 2011) – in this sense, public sector institutions mediate societal interests, and give shape to their realization in policy (privileging some groups but not others), but do not override those societal preferences, which remain causal in nature. However, state institutions and certain broader conditions may also serve to minimize the extent to which state officials are subject to societal pressure on a given policy issue: certain admixtures of institutions and features of a specific issue may create conditions of public sector insulation from societal pressure.

In a recent contribution on immigration policymaking, Ellermann (2013) usefully distinguishes between two types of insulation: “popular” (i.e., from the public) and “business” (from organized private interests). She notes Immergut’s influential comparative work (1992) on health policy outcomes across industrialized states, which argues that policy outcomes are determined by the relative centralization of decision-making and the relative insulation of executive actors from legislative and societal pressures (such as medical lobbies). As Ellermann points out, institutional factors determine the relative levels of insulation from popular pressures, for instance whether the legislature is elected by majoritarian or proportional rules – or whether there are more direct mechanisms of popular influence such as referenda or recalls. Political elites’ insulation from business pressure is also best measured by the constraints and opportunities afforded by institutions, including the degree to which public institutions

encourage corporatist decision-making processes and hence the degree to which business interests are embedded in policymaking processes.

As Culpepper notes (2011), however, the determinants of external pressure on policymakers – and by whom they are pressured – is not solely a function of institutional configurations, but is also dependent on the salience of the issue at stake and the subsequent mobilization of citizens and/or groups in response. This salience can vary with the content of the issue (its technical nature, its immediacy to individual experiences) or with “the vagaries of political life,” as Ellermann puts it: events or trends that can render an issue such as immigration more or less significant in the public’s eye, for instance a recession or a refugee crisis (2013, p. 502). There is no doubt that these issue salience effects are also at work in finance (Pagliari, 2013), and it also likely true that both popular and private sector mobilization do not equally affect all financial policy activity at any given time: in the recent financial crisis, some policy issues (OTC derivatives reform) were subject to more substantial post-crisis public attention and re-regulation than others (shadow banking). Salience clearly varies from one issue to another. Culpepper offers a matrix that predicts the subsequent logic of public decision-making, based on this varying salience:

Table 4

*The Governance Space (from Culpepper)*

	<b>Informal Rules Primary</b>	<b>Formal Rules Primary</b>
<b>High Salience</b>	Social partner bargaining	Partisan contestation
<b>Low Salience</b>	Private interest governance	Bureaucratic network negotiation

Source: Culpepper (2011, p. 181)

Where voters are unlikely to base their voting patterns on an issue, the bottom two ‘low salience’ quadrants describe the policy processes that will shape outcomes on that issue: where salience is low, policymaking will be driven by actors within private interest groups and/or within bureaucratic networks, depending on whether the process that is followed is “formal” and rule-based or not. According to Culpepper, the degree to which business has significant access to these decision-making processes depends on whether or not bureaucrats are following procedural rules precisely or are taking a more informal approach, including ad hoc consultations as well as participation in networks with interested business groups. This means that in some episodes of policymaking that is insulated from popular pressures, business pressures will remain relevant. The critical question regarding low-salience issue areas featuring business access and interest group activity, then, is whether that activity is formative and causal with regards to policy outcomes, or whether it is noise that does not end up capturing and/or driving public sector outputs. This critical question is indeed tested in the cases that follow.

In sum, then, to demonstrate that it is analytically appropriate to study market authorities’ preferences on an independent and insulated basis, it is necessary to assess whether:

- the salience of the policy issue as an electoral issue is such that popular pressures are low and the issue can be resolved in a non-public setting, and/or electorally-motivated officials are not empowered to make decisions;
- the formal and informal rules governing decision-making processes and decision-making bodies on the relevant policy issue allow it to be resolved in a manner that is insulated from societal (popular and business) pressures;
- business lobbying on the issue, where present, can be convincingly argued to be underdetermining vis-à-vis public sector preferences and decision-making.

In order to demonstrate the validity of the primary focus on autonomous public sector preferences as the causal factor shaping exchange merger outcomes, each of the cases is judged against these criteria in an interactive and additive manner. For instance, a politician may make public claims about an issue in order to position herself for electoral success, but that does not necessarily mean that the subsequent policy decision was made under rules that afforded that politician influence or causal input. To consider these causal nuances, then, the insulation of regulatory authorities is measured in the following ways: first, whether elected officials are actively involved in the decision-making process, unified in the direction of their pressure on the regulator, and/or hold a significant veto (rather than simply being vocal and politically engaged); second, whether there are formal rules or informal processes in place that give regulators a degree of shelter from the most obvious forms of electoral and societal influence; and third, whether business interests are organized and actively lobbying for a particular merger outcome, and – crucially – whether those interests are unified or advocating for different things.

Importantly, it may be valid to infer that regulatory decision-making is insulated even where political and/or business actors are applying some pressure on regulators, but those actors are mobilized in different, push-pull directions at the same time. In addition to making it analytically difficult to assert the primacy of any one group's policy preferences over others, such a scenario – perhaps counter-intuitively – also gives regulators a substantial degree of cover to pick the policy outcome that is most amenable to their own discrete preferences (Callaghan and Lagneau-Ymonet, 2012).

Where business and societal business influence is found to be absent or indeterminate, as is the case in the empirical cases studies in the subsequent chapters, an important question thus

emerges: what independent preferences do policymakers have regarding the internationalization of financial service firms?

### **Historical institutionalism: explaining sector preferences in global finance**

The theory of regulator dependence predicts market authorities' preferences regarding proposed, but not-yet-existing multinational firms. To identify the underlying causes of those preferences, the theory departs from the inference – discussed at length in the previous chapter – that the impact of international integration on public sector power is a reasonable and valid place to start looking: i.e., that market authorities will be mindful and concerned about that impact on their power and will consider it in looking at integration proposals.

Authorities' understanding of where they are going to end up (or likely to end up if an integration proposal goes through) is based on where they have been – and to judge the forward impacts of a proposal on their power resources they will necessarily consider their existing and historical power resources. The theory thus identifies the nature and provenance of regulators' existing power resources, and to do so it considers existing domestic arrangements that shape the domestic balance of public/private power and inform the degree to which international integration is more or less threatening to policymakers. To develop a model of regulators' preferences regarding private sector integration, the theory analyzes the historical trajectory of a jurisdiction's policymaking in the exchange sector and considers the contemporary impact of previous policy decisions – that is, the degree to which contemporary decision-making is contingent upon previous policy developments about the market and its oversight.

This strategy is broadly consonant with the historical institutional (HI) approach in political economy (Thelen, 2004; Thelen and Streek, 2005; Farrell and Newman, 2010). The

theory shares the HI premise that “institutions shape not only actors’ strategies but also their goals” (Farrell and Newman, 2010, p. 616). In this way, actors’ goals are endogenous to the institutional context within which they are situated and the incentive structure provided by that context (cf. North, 1990; Pierson, 1994; Farrell and Newman, 2010; 618). The theory also adopts the HI view that previous policy developments have ‘feedback’ effects in that the temporal sequence of those decisions matters. In particular, the theory deploys inferences that were discussed in Chapter 3, above – inferences that suggest public power varies with the structure of the market and the structure of the jurisdictions that oversee the market. In this vein, the theory thus explains the effect of these historical policy developments by reference to the manner in which such institutional legacies a) shape the capacities and responsibilities of public and private actors, respectively, and b) shape the market itself. These types of historical policy outcomes establish the broader institutional context that public and private actors operate in. Again, this tactic reprises the HI approach that is “explicitly interested in the wider set of institutions that structure public policy regimes. This set naturally includes systems of regulatory oversight, policy rules that define market competition, and state systems of interest aggregation and mediation” (Farrell and Newman, 2010, p. 616).

Domestic historical institutional analysis has been increasingly and convincingly used to account for international policy outcomes, in international market governance arrangements generally and in financial markets in particular. Indeed, understanding the foreign economic policy preferences of states as a function of their domestic institutional configurations has an established history in political economy (Krasner, 1977; Katzenstein, 1978; Moravscik, 1997). The approach has been most commonly used in CPE and IPE to explain the positions that market authorities stake out in negotiations over international regulatory outcomes in integrated product

markets, with particular reference to the manner in which societal preferences over regulation are represented by or mediated through institutions (Bach and Newman, 2010a; Fioretos, 2010; Eberle and Lauter, 2011; Butte and Mattli, 2011).

It is important to note, given the focus on public sector preferences here, that HI is typically used to elaborate not only the preferences and power of authorities but also the manner in which domestic institutions are generative with regards private actors' preferences and power: as Fioretos puts it, with specific reference to the hedge fund industry,

[Historical] institutionalism draws attention to the historically contingent nature of national policy-making processes, including the role played by regulatory authorities in defining and enforcing securities regulation and the manner in which the financial services industry and other interest groups are incorporated into such processes. (Fioretos, 2010, p. 699).

This theory of regulator dependence does not share this focus on how “interest groups have succeeded in becoming embedded in the relevant regulatory decision making structure” (Farrell and Newman, 2010, p. 620). Instead, and as argued above, the theory presented here focuses on the causes and consequences of public sector preferences regarding integration, rather than the manner in which private interests are aggregated into policy decisions (see Chapter 4). This is an important analytical difference between existing HI and the present approach. Historical institutionalism asserts a more contingent and temporally dynamic approach to institutions than Open Economy Politics: institutions vary greatly and the policy decisions that give rise to them have important impacts on what is subsequently rational or even possible for stakeholders to pursue. But both focus on the role of state institutions in structuring the exercise and influence of societal, particularly interest group power. Indeed, the present study looks at private firms not as interests to be aggregated through institutions but rather as potential sources of

dependence for authorities – that is, it views firms as institutionally embedded components of the broader policy-delivery framework, on which regulators may or may not depend for their own efforts at policy execution. In this way, the theory has a different analytical focus but remains consistent with the broader HI approach. Private interests do not simply disappear from the causal dynamics detailed here, and indeed, the institutionalized dynamic of shared or delegated power between the public and private sectors has a critical impact on the public sector preferences that are observed.

Finally, the dissertation's broadly historical institutionalist approach does not mean that the theory is premised on a strong version of path dependence. The self-reinforcing logic of existing institutional configurations is a central premise of the path dependent approach in economics and social science, and has been subject to considerable theorization and investigation by economic historians considering the development of institutions – defined widely to include outputs as diverse as commercial products and inherited patterns of behaviour (David, 1985; Arthur, 1988 & 1989). Due to the development of preferences and undertakings that are adaptations and/or learned responses (and therefore endogenous) to existing institutions, those institutions develop their own constituents whose behavioural routines, beliefs, preferences, and expectations reflect their sunk costs in the institutional status quo (Pierson, 1994). This can make it difficult – i.e., costly – to make choices that break a given institutional equilibrium, with the result institutions are therefore both highly sticky and frequently overdetermining of interests and outcomes. This strong version of path dependence is not necessary in this theory, and indeed runs contrary to some of the more interesting empirical observations in the chapters that follow.

Regulators' preferences are very much embedded in the institutional context in which they act – a context that is historically-rooted – but it does follow that they are unable to change

that institutional context, or that they do not want to enact such changes because of their sunk costs. It is in fact entirely consistent with the predictions of the theory that regulators could choose to alter their institutional context on a forward basis to adjust the degree of their dependence on firms and, in that way, change their future path. This is observed in at least two jurisdictions in the cases that follow below; in a third, some individuals are observed to be considering a merger episode as something that could have an impact on their subsequent level of dependence down the line, and they weigh its pros and cons accordingly. In short, institutions are not destiny in this dissertation. They explain why regulators take the view they do on certain discrete policy choices, but they do not subsequently overdetermine the extent to which regulators can change the context they work in. Mahoney's evocation of a "reactive sequence" is valuable here, as he notes that "actor resistance to prevailing institutions or structures" when they either do not or cease to provide marginal benefit is entirely consistent with the deeper observation that institutions shape preferences, beliefs, and actions at any particular historical juncture (Mahoney, 2001: p10). If regulators decide after a merger episode to change their institutionally-rooted dependence on regulated firms, they can, and they do. This is not consistent with strong path dependence.

### **The theory of regulator dependence**

#### **Regulatory power**

The regulatory response to integration proposals depends upon the impact of those proposals on regulatory power. In Chapter 3 regulatory power was defined by its three component parts:

- Sufficient resources (material and statutory) to compel regulated private actors to engage in wanted activities and adhere to regulations, principles and rules – and to monitor that they do so;
- The ability to develop those regulations, principles, and rules with all due consideration for their impact on the domestic economy, in the context of broader domestic, political, and policy objectives;
- A significant level of private transacting and business activity taking place within the jurisdiction, giving regulators actual and not just nominal/statutory power over private sector activity.

The theory of regulator dependence proposes a) that regulators care about this power and wish to maintain it, before moving to b) outline a cost-based mechanism through which regulatory power is eroded by cross-border firm integration, and finally c) identify the circumstances under which regulators are likely to be motivated to prefer a domestic firm and block integration: that is, circumstances characterized by regulator dependence on the firm.

### **Regulators' incentives to maintain their power**

The inference that public sector actors will consider an international integration proposal in the context of its impacts on their power resources is well grounded in existing literature.

In general, what do market authorities want? What are their preferences? Political science has frequently taken the view that regulators have a preference to maintain and even increase the capacity of their bureaucracies and uphold – and even expand – their domain of monopolistic control and oversight (McNollgast, 1987; Carpenter, 2010). To do so, regulators deploy a series of strategies – including rules and procedures, reporting, monitoring and

consultation processes, punitive fines and other levies, and the cultivation of reputation and independence – with the backing of the state's coercive power, and they do so in order to shape the behaviour of regulated entities, monitor inconsistencies, and enforce compliance with their rules. In these ways regulators develop power resources through procedural and coercive mechanisms, and attempt to monopolize those resources and the policy domains over which they are exercised.

In addition to being monopolists, regulators also seek independence from their legislative overseers. Coercive state power is often delegated to regulators on an agency model, meaning that political principals establish an arms-length relationship with a regulatory authority and give it room to do its job independently, free from direct political input while also accountable to politicians (Epstein and O'Halloran, 1999). Principals do this for any number of reasons: to credibly commit to a politically difficult policy trajectory, to distance themselves from possible blame in the event of a crisis, or to build capacity and expertise in a body with a longer-term time horizon than political incumbents.

It is well-established that market authorities have strong incentives to do their jobs well in order to maintain this policy autonomy; regulators want to keep their independence, and so they seek to keep legislators and other political leaders from interfering in their exercise of power and daily routines (Singer, 2004, 2007). This means executing the various components of their mandate, avoiding market disruptions, and delivering outcomes consistent with the policy agenda developed by their political principals. Even in delegated systems, politicians care about outcomes in financial markets, and have office-seeking incentives to ensure that regulators deliver key policy goals in those markets – particularly the maintenance of stability and delivery of public goods like growth and efficiency. As Kleibl (2013) has recently corroborated,

regulators' desire to maintain independence by executing the goals set before them is highly rational, as regulators who are seen to have ineffectively or inefficiently managed their portfolios are replaced by their political masters at a significant rate – a phenomenon that is shaped by the deeply-held office-seeking motivations of politicians. Short of this extreme event, poor performance may also lead to unwanted political interference in and politicization of the agency. These varying outcomes are clearly undesirable outcomes for either an office- or policy-seeking regulator.

As a result, regulators strongly desire the power to do their jobs effectively. They may want power because they are policy-seekers who wish to ensure that their goals are met, and because they are not merely engaging in window-dressing or cheap talk. This can be explained at a micro-level, as a result of personal motivations, or at a more macro level as the effect of hiring processes, rule development, and mandate and institution building on the part of bureaucratic entrepreneurs. From the principal-agent perspective, regulators are also office-seekers who wish to retain their jobs, prestige, and independence, and as a result want to ensure that their mandates are fulfilled to keep legislators at bay (Singer, 2004, 2007). This of course requires the successful delivery of policy goals and regulatory objectives – which requires more than just nominal power and capacity. For the purposes of this theory it is unnecessary to distinguish between policy and office-seeking motivations, because both point to an overarching concern in the regulatory agency with maintaining power, measured as job-execution.

### **Limited regulatory capacity**

This preference for power, however, comes with a key corollary. While regulatory power exists and can be deployed towards generating private compliance with public rules, regulators

have limited material capacity, in the form of personnel and funding. They also have limited statutory capacity, meaning that there are real (jurisdictional) limits to the reach of their rules, to the scope of their monitoring activities (i.e., rights to data, to surveillance), and to their capacity to sanction offenses. It is therefore costly for regulators to produce rules, and then oversee and monitor private transacting to ensure compliance with them. Compliance is costly. It requires some kind of outlay; whether material, in terms of financial resources, staff labour, or institutional capacity-building; or in terms of political, reputational, or personal capital (i.e., at the level of human relationships). Regulators will seek to avoid or minimize taking on any additional costs given the constraints they face and the impacts of these additional costs on their power resources.

### **Cross-border firm integration: a costs-based problem**

Regulators seeking to ensure the realization of public goals in the market may need the compliance of important market infrastructure firms in order to achieve those goals (as is theorized below). Compliance is achieved through some outlay of resources, which will largely take the form of personnel and time.

Cross-border integration poses the following problem for regulators: *ceteris paribus*, the costs associated with regulating a cross-border firm are higher than the costs of regulating a domestically-contained firm. There are several reasons for this, but the core reasons are as follows:

- multinational firms create information and transaction cost problems for regulators because they are more complex to monitor and sanction;

- multinational firms introduce bargaining costs to regulators because they have multiple public stakeholders overseeing them. This makes them costlier to oversee in terms of time spent establishing goals for the firm, and reduces the likelihood that any single firm undertaking will overlap with a single regulator's preferences.

These costs eat into regulators' finite resources and reduce their capacity, and reduce the independence with which they exercise their power and thus their autonomy. They may also threaten a reduction in the absolute level of transactions that pass through the jurisdiction, further eroding regulators' power.

It is necessary to unpack with greater precision the implications of cross-border firm structures for regulatory power. For analytical purposes, it is worth subdividing these into two: the implications of cross-border flows of capital with the firm, and the effects of cross-border management of market infrastructure.

### **Mechanisms of power erosion**

**Cross-border flows.** Cross-border flows of capital present challenges for regulators seeking to control firms and their transactions, and chart an independent policy trajectory. This was elaborated above, and has been thoroughly investigated and debated in IPE and CPE.

A contemporary issue facing regulators of global firms is managing the impacts of cross-border capital mobility within a single business firm. A stark illustration of this phenomenon comes out of the trade literature, particularly that focusing on quantitative measures of trade, which has been grappling with the issue of "missing trade" statistics, i.e., trade happening within the firm as part of the production process. Multinational businesses move products (both goods and services) across borders, often several times, in order to take advantage of differential

expertise and costs in the various jurisdictions in which they operate (Hart and Dymond, 2008). Production within the firm may involve very high levels of cross-border trade as the firm re-allocates its assets across jurisdictions (which, it should be noted, can confound tax authorities as much as trade statisticians). Where the various stages of production are taking place - i.e., how much and what is being produced, and in what jurisdictions - clearly has distributional implications, evidenced by the decline of employment in traditional manufacturing by multinational companies within OECD states, as well as recent tax compliance disputes involving major multinationals like Starbucks.

In finance, this within-firm capital mobility can generate particular challenges for regulators. As firms increase their cross-border operations the impacts of their capital allocation decisions within the business firm will affect regulators' ability to manage systemic risk and protect their domestic constituents from negative financial externalities.

An example from the financial crisis illustrates this vividly (Norman, 2011). The bankruptcy of Lehman Brothers in September of 2008 led to a quick response from officials in multiple jurisdictions - Lehman was a global firm with operations, and therefore counterparty obligations, debts, and assets in many countries. In the UK, under British bankruptcy law, Lehman was put under the administrative control of Price Waterhouse Coopers, and the response was quickly coordinated between the FSA, Treasury, and Bank of England, as well as LCH.Clearnet, the London-based clearinghouse responsible for managing many of the firm's outstanding counterparty obligations and debts. Early on the morning of 15 September, these players moved into Lehman's Canary Wharf offices to examine its books and begin the process of minimizing creditor losses, ensuring liquidity remained in the system, and consolidating Lehman's assets to ready it for a bankruptcy proceeding. It was then that they learned that every

night, Lehman UK moved all of its cash to Lehman's New York operations, for the perhaps-ironic purpose of centralized risk management. That there was no Lehman money in London on that Monday morning, as everything had been wired back to New York, as it was every night. The UK authorities had no cash with which to begin their part of the wind-down, and as a result had very little leverage over how American authorities and others would determine which kinds of assets to liquidate and how, and which counterparty obligations to turn to first. This was both deeply embarrassing as well as problematic, as that lack of leverage meant that UK authorities had little power to shape the wind-down process to protect the interests of Lehman's exposed British counterparties and British financial product consumers. The British authorities have since taken steps to ensure that globally-operating firms do not deplete their coffers overnight, and yet cross-border contagion that spreads within a single financial service firm continues to be a front-of-mind concern for policymakers.

In the financial exchange industry, the mobility of cash within the exchange firm but across borders leads to eight potential challenges to the regulatory power of market officials:

- Regulators lose leverage over the firm, because exit costs for a cross-border firm are lower. It can direct investment and capital across regulatory boundaries more seamlessly, i.e., within the firm and across its branches or subsidiaries (depending on structure). This entails greater bargaining costs for a regulator seeking compliance with its rules or policy goals, because this built-in regulatory arbitrage mechanism means the firm can push back for a lower compliance burden or less restrictive rules (Culpepper and Reinke, 2014). This dynamic can be observed where exchanges are multinational.
- Similarly, a multinational firm is likely to seek to further reduce the cross-border transaction costs that it faces in moving its assets, and in that way becomes a source of

business and lobbying pressure upon the regulator to harmonize and/or liberalize its regulatory regime (Gourevitch, 1978; Mugge, 2010; Farrell and Newman, 2014a).

- A multinational firm is able to allocate capital towards business activities outside the jurisdiction – and may face shareholder or regulatory pressures to do so, which can lead to a “slow bleed” as less product and business development takes place in the home market, and thus a lower absolute level of capital market activity.
- A multinational firm may have fewer endogenous reasons to follow rules, because its revenues and profitability are no longer derived solely from outcomes in its home jurisdiction, but instead flow into the corporate coffers from activities in multiple jurisdictions. This makes costly exercises in persuasion, monitoring and enforcing sanctions more likely to be necessary; the assets and cash flows moving through a market may be redirected towards a foreign jurisdiction, and market's profits and activities may be reduced and consolidated in another market – meaning that management of the firm is more dependent on, and thus more responsive to the demands of regulators in the jurisdiction receiving the business' focus.
- Exchange firm activities that regulators wish to see appropriately funded in one jurisdiction (such as self-regulation) may be less of a priority than the development new product ranges, or even self-regulation in another jurisdiction, leading to a non-alignment of public and private regulatory priorities in the ‘losing’ market requiring a greater outlay of resources to enforce.
- It becomes more difficult for the regulator to influence firm level decision-making by exercising "moral suasion" and gain leverage via issue linkages; the firm's ability to redirect resources to other branches of the firm (i.e., in other jurisdictions) reduces the

effectiveness of the issue-linkage mechanism. This is because, *ceteris paribus*, a firm operating in multiple jurisdictions is less dependent for its profitability on the regulatory decisions made in any single jurisdiction, and on its ability to efficiently adjust to those decisions. It can simply refocus its business activity as rules and incentives change. This reduces the levers that regulators have (i.e., it takes away the stick of stringent regulation as a punishment for non-cooperation). Any punitive sanctions – official or otherwise – a firm faces for defecting from a regulator’s preferred undertakings will be less costly and more marginal in the context of its bottom line.

- In the event of an economic crisis or a financial shock with an impact on market liquidity or stability, scarce capital may be pulled out of one jurisdiction and redirected towards another, requiring either strong exercises of persuasion or the development of new policy tools to prevent it: similarly, during a fiduciary crisis for the firm, the exchange may “cut and run” and concentrate capital and resources within a single jurisdiction, at the expense of officials who have few if any policy tools to prevent it (Esptein, 2014b).
- Managing the various business activities of a cross-border firm enabled by this capital mobility breaks a regulator’s domestic monopoly (or oligopoly where multiple domestic authorities have a stake) of oversight, as foreign regulators now share in the oversight of the firm, have some capacity to direct its activities, and gain a stake in the firm’s undertakings. This introduces bargaining with the foreign regulator over the firm’s undertakings, the nature and content of regulation that has possible spill-over effects, the mode of inter-jurisdictional information-sharing, and the appropriate stringency or tenor of rules.

A second type of cross-border mobility also depends on the mobility of capital and also challenges regulators' power: the mobility of exchange *users* and their capital. Many integration proposals (like the OM-LSE proposal that was discussed in the previous chapter, but others as well) involve the lowering of barriers to exchange and investment across jurisdictional boundaries. Using Watson's terms (2007), this is an increase in 'spatial mobility'. These proposals may include the consolidation of trading platforms, the reduction in informational or procedural barriers to brokers and investors seeking to participate in multiple liquidity pools in multiple jurisdictions, and an overall lowering of the transaction costs facing clients who are seeking to conduct business in different regulatory environments. This higher level of client mobility presents the following two challenges to regulators' power:

- Increased client mobility reduces a domestic authority's regulatory monopoly, allowing exchange users to escape the regime and transact in foreign jurisdictions; in fact, it empowers the exchange firm to offer the option of transacting in foreign jurisdictions to exchange clients and users. This has been referred to as a "marketplace in regulation", maintained and offered by the multinational exchange firm itself (Romano, 1998; Brummer, 2008; Pownall et al., 2011b), wherein investors are relatively free to invest where and as they see fit, depending on which mix of compliance costs and regulatory benefits they prefer - i.e., a balance between market confidence-improving regulatory stringency and low-cost laissez-faire or self-regulation (Coffee Jr., 2007). By reducing the costs of transacting in multiple regulatory environments, it creates even more direct competition (Cerny, 1997) between regulators and leads to low-cost regulatory arbitrage opportunities for exchanging parties, heightening the risk of a race-to-the-bottom.

- Increased mobility introduces the regulatory preferences of foreign authorities into the domestic market in a direct way, by giving brokers, listed firms, and exchanges authorized under foreign processes access to a marketplace that falls under a different authority; this reduces the domestic regulator's capacity to protect investors in ways deemed necessary by domestic legislators, and therefore puts the autonomy and capacity of the regulator to pursue domestic priorities around investor protection and enforcing standards at risk; managing and re-authorizing these mobile users in order to preserve direct oversight and thus capacity involves a substantial outlay of material resources by the market authority.

A significant and plausible objection can be made to the claim that a cross-border financial service firm will pursue commercial ends that are necessarily contrary to the goals and preferences of any given set of regulatory authorities. Indeed, by viewing regulatory-firm interaction as an iterative game rather than a one-off interaction, it is not unreasonable to expect that a forward-looking financial service firm could have strong incentives to cooperate with both its home and host market authorities in order to avoid sanctions, discipline, and reputational risk in the future. Such a firm would therefore not defect from any particular contract (implicit or otherwise) that it has struck with its public sector supervisors by shirking on the delivery of particular policy promises or commercial goods. In short, through the prism of an iterative game, cooperation may well outweigh defection as a dominant strategy for a cross-border financial service firm. While reasonable, there are two problems with this counter-argument.

The first is an issue of credibility and certainty. While regulators may believe that a merged corporate entity *could* have incentives to cooperate, it is very difficult for a structurally changed or changing firm – both in terms of corporate and management structure – to credibly commit to

such cooperation on the basis of the expectation of repeated future interactions with particular regulators. Indeed, one of the critical regulatory concerns relating to this type of merger is that the management team is necessarily changing and unknown, meaning that a previous track record of cooperation is absent and a future track record of cooperation is unknowable. Simply put, they do not have beliefs in place regarding the likely behaviour of the firm. Relatedly, regulators are concerned that where a management team is cross-border or especially if it is located in a foreign jurisdiction, any repeated interactions that would be expected to lead to cooperation may indeed be with a foreign authority rather than themselves. This is why in many mergers the promise of a specific allocation of management or board seats to individuals domiciled in certain locations is required, but it is only an imperfect solution to what may be an intractable problem. The inability of firms to commit may also be as a result of existing regulatory or market structures – for instance, if a merger takes place across markets with differently attractive regulatory or economic profiles, it would be difficult and indeed irrational for firms to commit to participating in both markets equally and attending equally to the concerns of regulators in both jurisdictions. Moreover, even where firms try to commit (and of course, many do in public and private statements) and even if their commitment is partly credible, the challenge of monitoring for compliance with or shirking of that commitment presents costs to regulators that – given their limited material resources – they do not want to pay out, as is theorized here.

Second, and briefly, it is worth noting that beyond these theoretical challenges to the ability of cross-border firms to credibly commit – and for regulators to accept their credibility – there is an empirical track record that demonstrates many instances of commitments broken, both in finance and elsewhere, or at the very least the tendency of cross-border firms to seek synergies

and efficiencies that do not allow for an equal treatment of all jurisdictions in which they are active, especially during fiduciary crises. To reiterate, this need not be the sole expectation or even the most likely outcome in any given merger proposal for regulators to be mindful of it, and to question whether or not the firm has incentives to concentrate its activities elsewhere and leave them in a less enviable position. Indeed, the theoretical claim being advanced here is that this is one of many – additive – concerns that regulators could have about mergers, and as a result it should be one of many concerns observed playing on regulators’ minds in the empirical chapters, below. More importantly, it must be considered that this problem of firm defection is a) only a concern, not an assumed fact by regulators, and b) likely to take on greater weight in regulators’ calculations where they are dependent on the merging firms. In short, the trade-off for regulators is considerably more steep when they are dependent on a firm – in such a case, a credible commitment problem (even a potential one) is likely to weigh heavily indeed.

A second and related objection is that a cross-border firm need not be subject to competing and necessarily contradictory requirements from different regulators, making the costly bargaining challenge – whereby a regulator’s monopoly of oversight is broken and its costs increase as it must deal with a foreign counterpart – less significant and material than it is presented here. On the surface the objection is valid, inasmuch as regulators in two jurisdictions may ask similar, complementary things of the firm: presuming a zero-sum relationship would not necessarily be empirically or theoretically valid. That said, a similar response to this objection may be made, namely that the uncertainty regarding the need for negotiation and bargaining with a foreign authority rather than the rump expectation of specific costs on specific issues of disagreement is what drives regulators to have cost-based concerns about a merger. And indeed, in many mergers a memorandum of understanding is deployed in order to mitigate precisely

these bargaining costs on an ex ante basis; however, where the motivations of the firms and their likely centre of economic gravity is not certain, and the future direction of a foreign regulator's policy preferences and political direction are unknown (and unknowable), the potential for political dynamics of this sort to emerge on a cross-border basis is likely to be unattractive to market authorities. Again, the extent to which these bargaining costs are an intractable threat rather than simply a manageable potential complication is a function of dependence for regulators as they calculate their interests in merger scenarios, as is theorized in more detail below.

**Cross border management.** The key difficulties facing regulators when financial infrastructure firms are managed by corporate leaderships located in different jurisdictions were just alluded to: the potential that a management team that is disembodied from the domestic economy may a) pursue business strategies that are unfavourable to one jurisdiction, and/or may b) come under pressure (from shareholders, users, or foreign market and political authorities) to promote one market at the possible expense of another.

This is an issue of capital mobility, but it is also a problem relating to the separation of firm "mind and management" from the local infrastructure it manages. No matter what they are trying to do, it is important that regulators retain access to the firms they oversee in order to have power and influence over firm-level decisions and therefore outcomes. Indeed, public authorities' access to a private firm's leadership is very important when it comes to that leadership's decision-making. Access enables conversations and consultations that ensure regulations are feasible, not unduly harmful or costly, will be taken up by private firms, and may even reflect some shared priorities. Access establishes trust between regulators and regulated entities and helps foster coordination around public policy goals. And access ensures that

regulators can deploy both formal and informal enforcement and compliance activities, including "moral suasion" but also the use of litigation and the levying of penalties – efforts that are made much more time-consuming and complex when they extend across borders. Ultimately, if access to management shapes firm decision-making to some degree, it will have an impact on where and how a firm deploys its capital, in terms of human resources, business capacity, regulatory funding, and crisis management strategy.

Cross border management dilutes access in the following ways, each of which increases the material costs to regulators trying to influence the firm's decisions, or reduces their autonomy in determining the priorities to pursue in the exchange industry:

- Key exchange personnel are likely to be more difficult to access, influence, and sanction.
- Cross border management reduces in number, frequency, and intensity the personal relationships between financial and policy elites.
- Cross border management interests into management circles from outside the domestic policy community, in terms of board memberships as well as at senior levels of firm management.
- There is a potentially unwanted spillover effect (Mosley, 2011). The governance of a cross-border firm by public actors and private managers introduces foreign regulatory, legal, and investment cultures and expertise into the existing policy network - which may have the effect of diluting the domestic focus and knowledge base of the firm; a cross-border firm management team is more likely to make business decisions that are shaped by different business cultures and embedded in multiple (or even entirely foreign) institutional contexts. It may prioritize business activities that are desired and desirable for actors in one jurisdiction but not another - and with neither the same strong

interpersonal ties nor the same incentives to tailor business to a particular market context, both formal and informal firm incentives may be less aligned with the incentives of their regulators'. The interpersonal and reputational resources that make commitment and coordination possible in so-called 'iterated games' are thus likely to be eroded by cross-border mergers (Miller et al., 2002). So, too, will be the relevance of focal points around which multiple firms business decisions are made, and which are often crafted and reinforced in informal social contexts as well as through official activities.

- Informal considerations around responsibility to the home market and its participants, vision, and even nationalism are likely to fall away to cross-border profitability and efficiency considerations.
- It introduces a 'slippery slope,' through the potential for further mergers and therefore additional dilutions of any one jurisdiction's influence over the integrated firm.
- Where regulators monitor not just the exchange but also the holding company of the exchange, a change in ownership may put a crucial component of the oversight framework –over the holding company and its decision-making and resource-allocation decisions, including decisions about the funding and focus on self-regulation – out of reach of the domestic authorities.

This final mechanism points to one of the more significant impacts of cross-border exchange mergers, which is its effect on industry self-regulation as a component of market governance. Cross-border integration makes systems based on self-regulation more difficult by diluting the alignment between public authority and private managers in two ways. First, consolidation in this industry reflects a broader change towards a corporate model driven by exchange-first commercial imperatives, and away from a mutualized (member-owned) system

designed to benefit the exchange's users. An alignment between regulators and not-for-profit private actors operating on a cost-recovery basis is likely to be greater than where the private actor is publicly owned and therefore governed by shareholder value considerations (like most present-day stock exchange firms) (Fleckner, 2006). Exchanges are presently driven by cost synergies and the opportunity to add value, rather than political goals such as (for instance) providing a venue for domestic mid-cap firms to raise capital. Cross-border merger proposals can bring the non-alignment of public and private priorities into relief by moving management ever further away from the sphere of political influence that makes self-regulation 'safe' and manageable for authorities.

Second, alignment is likely to be diluted with the introduction of cross-border business activities and international management structures. The logic here is that, in finance like in other domains, particular markets may have distinct comparative advantages. In the minds of many policymakers, those differences may be sources of strength worth protecting, rather than simply a reflection of institutional sclerosis or successful lobbying by protectionists (Fioretos, 2011). A domestically-focused and domestically-managed firm may be a valuable infrastructure-side partner if the public goal is to retain and reinforce those strengths (cf. Enderlein, 2011). Because both it and its clients have sunk investments into that particular business environment, it is able to commit to particular policy trajectories – an entire collection of private actors is thus incentivized to reinforce existing comparative advantages rather than knock them down to ease cross-border frictions. This commitment is obviously more difficult with a cross-border firm operating in multiple jurisdictions, which will be more committed to easing cross-border transacting than reinforcing national comparative advantages.

Exchange mergers present clear dilemmas to regulators. Any particular merger may reduce a regulator's autonomy, capacity, and power in any number of ways – and is likely to do so. These mechanisms of power erosion, combined with the regulator bias towards power maximization, ought to make any cross-border integration proposal highly problematic from a regulator's point of view. That, indeed, is a finding of the empirical research presented in the following chapters.

However, in only some cases do these concerns reach a tipping point and lead regulators to step in and block a merger by interfering in the market for corporate control of the exchange. Why – what is this tipping point?

### **Regulator dependence**

An important and logical extension of the preceding discussion is that the costs of overseeing a cross-border firm are always higher than the costs of overseeing a domestic firm; they always have less power over a cross-border firm as a result. Because regulators have strong incentives to execute the tasks set before them, and because they have limited resources at their disposal, these costs are material and undesired – making it rational for them to block cross-border merger proposals involving the firms they oversee.

Those costs become particularly important and – crucially – only become insupportable for market regulators in the context of their dependence on the firm. This is a crucial distinction, and it explains why there is such clear variation in responses to major infrastructure merger proposals rather than a uniform tendency – rational under the costs-based logic detailed above – for authorities to block them all. In fact, there are several, additive reasons why regulators

would not simply block all mergers as a matter of course, to ensure that they can continue to regulate on the basis of status quo arrangements.

First, public sector interference in the market for corporate control for reasons other than anti-trust could be construed as a draconian measure that runs contrary to contemporary ideas about the appropriate boundaries of state intervention into the economy (Abdelal et al., 2010), and it is always likely to be a “noisy” event, one that would attract considerable public attention, critical commentary, and media coverage. In short, it is unlikely to pass unnoticed and to the extent that reputations for openness and comity are valued by officials and their political bosses, then it is reasonable to infer that regulators would maintain a bias against protectionist undertakings that would harm that reputation.

Second, and on a less normative basis, it is also reasonable to infer that such reputational impacts may carry material costs, as displays of nationalism and/or protectionism in cross-border corporate merger cases may dissuade potential investors down the line (Dinc and Erel, 2013; cf. Li and Resnik, 2003). It is rational for regulators to expect that moves with negative future consequences for FDI and related cross-border transactional and investment activities would result in negative political attention that – if not justifiable – could result in censuring of the regulatory agency and its agents. Indeed, these are potential consequences that market regulators are likely to wish to avoid, except where necessary. That is, the risks of interference must not outweigh the opportunity costs of inaction on a merger proposal.

Third, this presumption of a general bias against interference in the market control is also justified on the basis that such decisions are tangential rather than intrinsic to regulators’ mandates. It must be stated that market regulators are, by their very nature, significantly interventionist: they exist primarily to police market failures, a mandate which requires a

substantial capacity to step in to the realm of private transactions and enforce some set of activities or outcomes. That does not necessarily mean, however, that regulators are strongly minded towards interference on every file that comes across their desk, and especially not on files that fall beyond the scope of those day-to-day market licensing policing activities. That is, they are not merger watchdogs – and indeed, such authorities exist. To the extent that market regulators have veto authority over mergers, it is often residual rather than explicitly encoded in their mandates: their ability to provide or refuse licenses and registrations, or approve/refuse firms’ by-laws and specific undertakings, results in a *de facto* veto over changes to holding company and corporate structure, rather than a *de jure* – and sanctioned – capacity to intervene in corporate control decisions regarding the firms they directly authorize. As such, is it likely that a decision to intervene is likely to be strongly tied to issues regarding oversight and capacity at a technical level, rather than simply a desire to use those technical tools (e.g., licensing) to block mergers as a matter of course. In short, the reasons to block a merger will likely be grounded in real technocratic impact analysis, which will mitigate strongly against any pre-existing bias to intervene.

As a result of these countervailing pressures against intervention, blocking a merger is likely to be considered a significant move requiring significant justification for most market regulators with the result that this measure is likely to be deployed only when the stakes are understood to be quite high.

Those stakes are a function of regulators’ dependence on the firm. Regulator dependence is observed wherever market authorities are unable to accomplish their policy and/or mandate-driven goals in the capital market without private firms’ compliance and/or cooperation.

There are three possible ways in which regulators can be dependent on private exchange firms: to achieve their desired market outcomes, to effectively shape private conduct, and/or to deliver on some set of public policy commitments. The higher the overall level of regulator dependence, the more likely authorities are to intervene in the market for corporate control.

**Causes of regulator dependence.** Where does regulator dependence come from? The level of dependency that is observed can be traced to two types of previous domestic policy outcomes:

- The allocation of regulatory authority over the market;
- And the structure of the market.

The statutory allocation of regulatory authority over financial markets has two impacts on the subsequent level of dependence. First, the exchange firm itself may be in possession of regulatory authority – de jure authority via public delegation to the firm on a self-regulatory model, or de facto influence (because of proximity to the market, control over capital resources, etc.) over the nature of market transactions. Regulators may delegate public authority to a private firm or standard-setting body to achieve desirable market outcomes (Dombalagian, 2007). As noted, this is most effectively done from a public authorities' perspective when there is a significant degree of overlap between the preferences of firms and regulators over how the market should be governed. For instance, where regulators and firms share an interest in mitigating risk, transacting in a transparent manner, establishing common standards to reduce transaction costs, or concentrating transactions on a particular venue, private firms can be tasked with setting the rules and procedures governing those processes, and with putting business energy behind the realization of those goals. An example of this was the historic alignment between stock exchanges and domestic regulators with shared interests in liquid, transparent,

fair, and efficient regulated exchange marketplaces (cf. Fleckner, 2006). As a result, many exchanges were allowed considerable self-regulatory powers to undertake trading, listing, and compliance rule-setting and enforcement. In such a system, regulators with market-side partners can see their agenda advanced and their power augmented, without the need to deploy agency capacity or develop in-house expertise related to the agenda at hand. While this equilibrium may be tenuous the efficiency benefits for regulators are clear. Public authorities may thus depend on the exchange to enact or enforce rules.

Second, the allocation of authority within the public sector shapes dependency in what might be called a “fingers in the pie” effect. The absolute number of financial market regulators has a strong impact on the absolute number of bureaucratic stakeholders in the undertakings of the private firm. The greater the number of officials overseeing a heavily-regulated firm, the greater the likelihood that somebody’s agenda, mandate, or policy priorities are going to be affected by changes to the governance and structure of that firm – i.e., some public stakeholder is going to be dependent on the exchange for something (see next section).

Two further types of historical policy outcomes – about market structure in particular – will have an impact on the level of dependency that is subsequently observed. Following Spendzherova (2014) but also Farrell and Newman (2010, 2014b), and Newman and Posner (2011), it is reasonable to infer that public sector preferences regarding international economic integration are rooted in the existing structure of the domestic market: that is, what kinds and numbers of market participants populate the market, and where they are allowed to transact has a direct impact on the subsequent level of market authorities’ dependence on the firm, making it possible to infer their preferences regarding proposals for further integration.

First, the level of competition in the exchange industry is a critical factor. To some extent this will be determined by market-level dynamics, not least degree to which there is sufficient depth of capital and trading interest in a particularly jurisdiction that it is rational for new market entrants to bear the sunk costs of entry and take on established incumbents. Indeed, there is substantial evidence – as discussed in Chapter 2 – that it is quite difficult to pursue organic growth strategies in the exchange market, for both the equities and derivatives markets, as the network effects in these industries provide notable downstream benefits for users of existing exchanges and make it difficult to ply them away to new venues. That said, competition has been meaningfully introduced in some jurisdictions as a result of considerable regulatory intervention (Quaglia, 2010, Gadinis, 2008a). As a result, market structure will also be meaningfully shaped by public officials’ efforts to lower barriers to entry and level the playing field in a market space with natural monopoly dynamics (Vogel, 1996). The extent of competition will reflect regulatory developments and often political decision-making regarding policy trade-offs, i.e., between the benefits of lower trading fees across multiple venues, versus the benefits of concentrated trading activity (Gadinis, 2008a.; cf. Derthick and Quirk. 1985). These market structure outputs, whatever their commercial, political and/or ideological sources, will clearly have an impact on the uniqueness and the importance of firms that subsequently populate the market. This is true in banking, where market structure concentration and too-big-to-fail concerns are highly correlated (Epstein, 2014a). It is also the case in the exchange industry, where single firms can dominate the provision of financial ‘plumbing’ – i.e., market infrastructure – for a jurisdiction and be seen as critical service providers as a result; or, of course, they may be one of several infrastructure operators and thus significantly less important.

Second, the structure of the market will also be a function of policy developments relating to the structure of individual firms – i.e., rules or decisions that shape the vertical and/or horizontal integration of various trading and post-trading facilities. A firm that features integrated services in multiple business lines such as stock trading, derivative trading, clearing and settlement, and ancillary activities like data provision is more likely to generate dependence for one or multiple public authorities than a firm specializing in only one of those market services. Again, this presence of a firm featuring this type of vertical, multi-service structure is not overdetermined by regulatory choices: sufficient demand for the service at a price that shareholders and/or beneficial owners are willing to support, as well as the presence of synergies between the various businesses proposed for integration in a single firm are key commercial variables that are beyond the scope of this theory but will feed into the types of firms that exist in the market. However, the concentration of functions in a single firm will also be due to two types of previous policy outcomes: first, decisions by market structure and regulatory authorities to allow integration between different components of market infrastructure; and second, efforts by political and regulatory officials to encourage integration, perhaps to buttress the market position of a “corporate champion” or as a result of effective lobbying by private firms seeking efficiencies through standardization and integration. In general, the number of firms in any given product market and the activities of those firms will shape the degree to which authorities are dependent on them to achieve particular goals.

These different types of historical policy legacies shaping the governance and structure of the market have direct consequences for the level of regulatory dependency that may be subsequently observed in that market. As a result, they are critical causal variables and provide the antecedent conditions for dependence to subsequently take hold – or for it to be avoided. In

short, they structure the relationship between regulators and the firms they oversee, by creating conditions in which regulators depend on firms to set appropriate rules for the market, deliver critical market infrastructure, or act as a market-side partner on key policy initiatives.

The broader implication is that these policy legacies have a direct impact on the subsequent level of cross-border integration that market authorities will support (whether or not they were responsible for the historical policy decision). Indeed, they result in a fascinating irony: that regulators that are more dependent on unique, dominant, powerful financial service firms are *less* likely to acquiesce to such firms' efforts to integrate on a cross-border basis. The result is a domestic historical-institutional explanation for the depth and extent of cross-border financial integration that regulatory authorities are willing to support (cf. Farrell and Newman, 2010).

**The causal logic of regulator dependence.** What does regulator dependence look like in practice – how does it function? Market regulators may be dependent on market infrastructures in three different ways:

- to achieve desired market outcomes
- to deliver desired private conduct outcomes
- to execute public policy priorities.

First, regulators may depend on market infrastructures to help them achieve market outcomes, i.e., those that encourage growth and investment in the domestic economy. The degree of dependency is likely to vary with the type of financing mechanism prevalent in the economy: in some markets, banks predominate and financing is mostly achieved through non-market mechanisms (Zysman, 1983; Hall and Soskice, 2001), reducing the dependence on

capital market infrastructures from a financing perspective. But in other economies, market-based capital formation is critical to driving investment and growth – and even in bank-dominated systems, market-financing mechanisms can become attractive to policymakers, for a variety of reasons (see the third type of dependence, below). This makes it difficult to predict this type of dependence based on the variety of capitalism alone.

In market-led economies and economies leaning towards market financing mechanisms, firms that need capital should be able to readily access large pools of capital-rich investors, without facing onerous transaction costs. To enable this, the domestic market must be sufficiently liquid, deep, and efficient so that its participants can meet their financing and/or risk-mitigation needs on reasonable terms and with some certainty.

Public officials may be dependent on market infrastructure firms to deliver these outcomes because of the market's structure and because of the delegation of authority. First, market infrastructure firms can be unique or dominant service providers within a jurisdiction. Until quite recently, stock exchanges and other infrastructure firms often operated as national monopolies, protected by regulatory walls from both domestic and international competitors. In many jurisdictions the competitive landscape has changed, as will be established in the cases below. Despite the widespread introduction of rules to promote competition, many public officials are still dependent on dominant domestic infrastructure firms to provide key market services like listings, trade execution, and clearing and settlement. The main reason for this ongoing dependency is that liquidity is 'sticky' and has natural monopoly properties.

Additionally, dominant infrastructure firms may operate as “anchors” around which a broader ecosystem of market professionals and intermediaries operate (Wojick, 2011). These experts create a base of knowledge and specialization that can make the jurisdiction's capital

market highly competitive, akin to a “clustering” effect that has been observed in many sectors of the economy (Porter, 1998). This can lead to a public sector dependency on the exchange firm to provide the network effects that support end-users of market infrastructures by creating a dense network of financial service experts and offerings. The “anchoring” of an industry has the knock-on effect of supporting market actors with sunk costs in business tied to the exchange.

Officials can also depend on exchanges to ensure that the market works as it should, so that the trading venue sits atop a sufficiently liquid pool of capital to meet market participants’ needs. Market regulators may therefore depend on an exchange firm if they have delegated some authority to the firm to develop market rules that incentivize business activity and develop liquidity. This is a difficult thing for public sector to achieve alone, firstly because they are at a remove from the market and its incentives and technical expertise, but secondly because (statutorily) they do not always have the capacity to set all of the rules that would make a difference. Exchanges often set many of their own rules that have important impacts on the liquidity and efficiency of the market. In particular, exchanges can tailor their trading and listing rules to ensure they strike an appropriate balance between prudence and fairness, and efficiency, i.e., rules that do not impose unnecessary costs on market participants. In this way, exchanges’ rules may meet the particular needs of participants – around disclosure, for instance –without administrative or compliance requirements that would reduce market actors’ incentive to participate, which would lower both liquidity and efficiency. Practically speaking, exchange firms’ proximity to their end users can afford them a privileged role in tailoring rules that work for the particular market in which they operate.

Identifying the degree of this type dependency thus involves assessing:

- The overall role of the infrastructure firm in the market: is the financing system bank or market-based? How unique is the firm in the economy? What is its market share?
- The degree of specialization in the capital market, and the exchange firm's role in supporting or encouraging that specialization.
- The market rules over which the firm has authority, and their impact on the market.

Second, regulators may depend on infrastructure firms to help deliver private conduct outcomes, in ways that are shaped mostly by the allocation of authority but also regarding the role of the firm relating to data collection. Conduct issues are those most closely associated with regulators' market-oversight mandates: the protection of investors, the maintenance of market integrity, and the mitigation of systemic risk - each of which has multiple (and overlapping) dimensions. Important components here include rules prohibiting insider trading and ensuring open and equitable trading practices; establishing disclosure, transparency, and governance rules for listed firms; ensuring business-continuity and systems maintenance in the event of a disaster or glitch; and elaborating prudential standards, including collateral requirements and wind-down/default proceedings that protect against contagion.

Notably, as there is potential for high-profile incidents and crises to emerge in the realms of investor protection or market fairness, these domains are highly likely to create problems for political actors should something go wrong. It is therefore critical for regulators to deliver on their mandate in the context of their principal-agent relationship. In some cases, private infrastructure firms have the authority or responsibility to make (or strongly influence) and enforce ruleset in these domains. Where firms have that power, it is clear that their regulators are highly dependent on them to help deliver private conduct outcomes that keep them in good standing with their political principals. Moreover, private infrastructure firms may have roles to

play governing the creation and collection of private transaction data that gives authorities a clear look-through at transacting in the market, and also drives private conduct enforcement efforts.

Measuring conduct dependency is a matter of assessing:

- Where authority to make and enforce rules relating to conduct is held, i.e. the allocation of formal and informal regulatory authority across public and private actors, including at the exchange level, the operator level (the holding company), between regulatory bodies, or through a separate organization that is retained by infrastructure firm.

The third and final type of dependency is for the execution of public policies. This category refers to discrete projects or programs aimed at enacting changes in the capital market, and which require a market-side partner to execute – either because the firm is the only viable option, or because the power to develop rules lies with the firm (Enderlein 2011). The dynamic that differentiates this category from the others is that it includes changing and even transient political and policy goals. It is worth unpacking in some detail.

From a principal-agent perspective, Singer (2004, 2007) explains when regulators will be more or less concerned with prudential regulation or with regulating more loosely to promote firm profitability and competitiveness. The intuitive point there is that regulatory priorities can change with exogenous shocks, such as financial crises – a finding that has recently been corroborated by Pagliari (2013).

Moreover, Singer notes that the agenda will also vary for endogenous reasons: regulators will be more inclined to engage in international standard-setting when doing so does not hurt the competitiveness of domestic industries, for example. Moreover, it will shift as ideas about what constitutes effective policy choices and outcomes change (Kapstein, 1989; Blyth, 2002), or

particular policy approaches diffuse across the global system and different regulator strategies emerge as a result (Simmons et al., 2004).

Finally, an agency may gain or lose capacity for a host of budgetary, legal, or political reasons. A gain or loss of capacity can render certain administrative and enforcement efforts more or less feasible, which can cause an agency to expand and bring new issues area under its ambit – or cause it to turn away from certain policy issues. In a contemporary example from the realm of financial regulation, recent legal decisions by US appeals courts against the SEC and the CFTC have vacated new rulemakings by those agencies, including the CFTC’s first attempt at redesigning the position limits regime for commodity derivatives. The agencies were found to have insufficiently undertaken cost-benefit analyses justifying the imposition of regulations on certain private undertakings (nominations to boards of directors in the SEC’s case; and new position limits for derivatives trading in the CFTC’s case). These decisions may result in more principles than rules-based regulation in the future – which will have an impact on the kinds of transactions, and thus the policy realms that American regulators can move into and oversee. The forward agenda will be at least partially shaped by these considerations about appropriate procedures, and their impact on regulatory capacity.

Public policies that require a market-side partner to execute may include the following: efforts to increase financing opportunities for particular types of firms; changes to the terms of access to financial markets for some or all market participants; the development of new requirements for market transactions, i.e., where and how market actors transact; the development of new products to facilitate growth or guard against risk in a particular sector of the economy; etc. Infrastructure firms may be uniquely positioned to help regulators execute

such policy goals, as public officials are unlikely to have or build the capacity to execute those plans unilaterally.

At any given juncture and within any particular jurisdiction the agenda is not prohibitively difficult to identify with some certainty. It is elaborated within legislative programs and proposals as well as administrative policy statements, and can be shaped by international coordinative efforts led by multinational institutions such as the G20/FSB, IOSCO, and the Bank for International Settlements/ BCBS. Public statements such as speeches and press releases reflect the agenda and give it additional shape. In the highly technical realm of financial regulation, various consultations, position papers, and calls-for-comments are abundant on salient issues that are occupying the regulator's energies – and they are largely public. The agenda also reflects existing mandates as well as the regulator's historical activities and even its reputation for certain kinds of focus – for example, the American SEC will always have a 'retail investor protection' agenda. It is therefore quite possible to determine the agenda – both as an external scholar and as a regulator – and make assessments about the impact of a merger proposal on that agenda. Whether the merger is assessed to be compatible or incompatible with the broader policy agenda, and thus whether or not it is detrimental to the exercise of public power, will determine the bias officials take towards it.

As such, regulators' dependency on infrastructure firms for the execution of policy outcomes must be assessed in a contextual manner, taking account of:

- The public policy goals or the broader policy agenda observable when a merger is proposed, and how those plans implicate the merging firm(s).
- The uniqueness and capacity of the infrastructure firm, particularly in the context of that agenda – i.e., its status as a prospective partner.

- Public statements or public documents pointing to specific firms or sectors in the context of public policy delivery.

### **The implications of regulator dependence: linking costs and preferences**

Cross-border management structures increase the costs to regulators of getting a cross-border firm's compliance, and they introduce bargaining with foreign regulators with influence over the firm; where regulators are dependent on the firm in the ways outlined here, they are likely to deem those additional costs and the concomitant loss of power to be unsupportable. Because the types of dependency developed here are conceptual categories intended to enable analysis rather than discrete categories within which decision-makers frame issues, no single type or number of dependencies is either necessary or sufficient for regulators to block a merger. Instead the effect is likely to be additive, and generally the more dependent a regulator on a firm – across issue areas, capacities, and policy domains – the more likely it is to move to avoid the additional costs of regulating a cross border firm.

In short, then, the overarching prediction of the theory is that regulators that depend on the cooperation and/or compliance of private exchange firms to fulfil their domestic mandates will block or impede cross-border mergers involving those firms. As the level of regulator dependence on a firm increases the likelihood of public approval for a cross-border merger involving that firm decreases.

### **Observable implications of the theory**

The theory generates four sets of observable implications, which are subjected to empirical testing in the case studies that follow.

To elaborate the standard against which the theory will be empirically tested, for each set of observable implications the dissertation follows the logic of process tracing elaborated by Van Evera (1997), Collier, Brady and Seawright (2010), Mahoney (2010), and Collier (2011), under which the types of empirical process evidence that ought to be observable are identified. To the extent that the expected empirical process data is found to be consistent with observed empirical process data, it is important to then assess the degree to which those observations support, corroborate, or confirm the expectations and the broader theory. That is, each component of the theory is subjected to one of four tests, elaborated by Collier as follows (adapted from Collier 2011, p. 825):

- Straw-in-the-Wind Test: Passing affirms the relevance of a hypothesis but does not confirm it. Failing slightly weakens a hypothesis but it is not eliminated.
- Hoop Test: Affirms the relevance of a hypothesis but does not confirm it. Failing eliminates a hypothesis.
- Smoking-Gun Test: Passing confirms a hypothesis. Failing somewhat weakens a hypothesis but does not eliminate it.
- Doubly-Decisive Test: Passing confirms a hypothesis and eliminates others. Failing eliminates the test

Finally, it is important to note that these four groupings of expected observations are not identical in terms of the types of challenges they present to the theory. O1 and O2 are high-level expectations of what we should observe in a given case if the theory is indeed a good explanation of some set of regulatory outcomes in that case. O1 and O2 may or may not be generally true statements of the conditions that broadly exist across the universe of merger decisions. However, to the extent that O1 and O2 do not hold in a given case, the case is one in which we

would not expect the theory's logic to apply. Put differently, O1 and O2 help identify the scope conditions under which the theory can be expected to provide explanatory leverage.

Conversely, O3 and O4 are hypotheses. That is, they are relatively straightforward empirical tests of the theory's expected observations in cases where O1 and O2 apply. If the anticipated values are not observed – and the related causal process expectations are absent – then the theory is weakened, especially because in cases with positive findings vis-à-vis O1 and O2 the theoretical logic ought to apply. To the extent that the expected observations related to these two hypotheses are observed, then the theory's primary empirical expectations are confirmed, which gives the theory considerable leverage.

*O1: Societal pressures do not direct regulators' decision-making when it comes to their responses to cross-border merger proposals.*

If the theory of regulator dependence is valid for these cases, we should expect to observe some or all of the following:

- A relatively low level of electoral salience regarding the merger, making it a regulatory issue but not an electoral issue activating politicians' office-seeking incentives.
- Decision-making by authorities who are isolated from direct electoral pressures by institutional rules.
- Limited business lobbying OR multivalent business lobbying on the outcome OR strong business lobbying that does not get its way.

These three empirical expectations represent hoop tests for the theory. The observation of these three types of process evidence is necessary to demonstrate that regulators' decisions (are highly likely to) reflect their independent preferences regarding cross-border mergers, rather

than the preferences of political office holders, voters, or interest groups. The remaining causal components of the theory remain plausible as a result, although they are not in any way supported by the observation of insulation.

Failing to observe this expected process evidence disproves the applicability of theory of regulatory dependence: a high degree of political and/or societal pressure introduces an entirely different set of causal mechanisms. Insulation is thus a necessary but insufficient condition for regulator dependence to be a causal explanation (cf. Mahoney, 2010).

*O2: Regulators have concerns about the costs of regulating a cross-border firm and this shapes their approach to cross-border merger proposals.*

If the theory of regulator dependence is valid for these cases, we should expect to observe some but not necessarily all of the following:

- Fact-finding efforts and/or studies assessing the complexity, difficulty, risks, and challenges for public sector officials stemming from merger proposals; or a record of *ad hoc* meetings, conversations, and working groups to that effect.
- Statements (public or anonymous) by regulators proposing that the complexity or difficulty of regulating a firm would increase due to a proposed merger, or that they had concerns that it would increase.
  - These can include statements regarding one or more of several different ways in which the costs of oversight and compliance are theorized to increase, including: the spillover of rules, the dilution of access, the reduction of influence, the loss of jurisdictionally-bound legal capacities, the increased mobility of market participants, etc.

The first and second types of process evidence suggest strongly that the theory's assumptions about regulators' objective functions are valid, because merger proposals lead them to worry about assuming additional costs that could impede the execution of their market oversight responsibilities.

- Statements by informed observers that regulators were concerned about the complexity or difficulty of regulating a firm due to a merger.

The third type of evidence collected from informed observers is similar but weaker: it corroborates but does not confirm the inference regarding regulators' objective functions as strongly.

- Where a cross-border merger is allowed, subsequent concrete efforts directly intended to minimize the complexity or difficulty associated with regulating a cross-border firm.

The fourth is strong empirical evidence confirming that the theory's assumptions about regulators' objective functions are valid because it confirms that all regulators are inclined to act to reduce those costs. Furthermore, it corroborates (but does not prove) a key theoretical claim – that regulators share concerns about their capacity and autonomy to deliver the market outcomes they seek, but they vary in how they address those concerns because their relative weighting of the overall impact of mergers on their capacity and autonomy varies. This important theoretical claim is rendered more plausible by the observation that even regulators that do not block mergers seek to reduce the complexity or difficulty of governing cross-border firms. The significance is that the cost-based causal mechanism contained in the theory of regulator dependence is universal, but it only leads to blocked mergers in the presence of an additional condition: regulator dependence.

These are each straw in the wind tests for the theory. The observation of any one of these four types of process evidence strengthens the causal claims contained in the theory of regulatory dependence, but does not prove the theory. The strength of the causal claims increases as more process evidence consistent with this broad expectation is observed. However, failing to observe these concerns about costs does not mean that the theory is incorrect, because concerns about costs may not necessarily be empirically verifiable in all cases.

*O3: Regulators block mergers involving exchange firms upon which they are dependent*

If the theory of regulator dependence is valid for these cases, we should expect to observe some but not necessarily all of the following:

- Statements by informed observers that a regulator's decision to block a merger proposal relates to dependence on the exchange firm, consistent with the forms of dependence identified in the theory

The first piece of empirical evidence – statements by informed observers – is a weak straw in the wind test. It is not necessarily the case that outsiders would have privileged access to the decision-making rationale of regulators and they may even endorse perspectives to the contrary (i.e., editorialists may blame nationalism). However, multiple accounts by journalists or stakeholders (who are understood to have privileged information) referring to the dependency-based reasons for blocking a merger help increase the overall support for the theory of regulator dependence.

- Statements by regulators involved in the decision to block a merger that they are dependent on the exchange firm, in ways consistent with the forms of dependence

identified in the theory – and/or public statements, documents, deliberation records, or policy positions from which that dependence may be inferred

OR

Statements by regulators involved in the decision to allow a merger that they are not dependent on the exchange firm (i.e., that the firm is not a source of dependency in the ways identified in the theory)

The second types of empirical evidence are weak smoking guns: if observed, they show clearly that regulators are aware of their degree of dependency on private firms, and they also suggest that the types of dependency regulators are aware of correlate with the predicted outcomes. That allows us to infer with some confidence a causal relationship between regulators' assessments of dependency and their actions on mergers. Statements to the converse weaken the theory.

- Statements by regulators involved in the decision to allow or block a merger that they are dependent in some degree on the exchange firm and that this level of dependence caused them to allow or to block the merger, consistent with the forms of dependence identified in the theory

The third type of empirical evidence is a very strong smoking gun: not only does it show that regulators are aware of their degree of dependency on private firms but it directly links that dependence with their decision-making on cross-border merger proposals. That allows us to infer with great confidence a direct causal link. Evidence to the converse, such as “we were dependent BUT it did not shape our decision” is damaging to the theory but does not eliminate it so long as contravening evidence is available.

- Observations of objective measures of regulator dependence, assessed in terms of the allocations of regulatory authority, types of market structures, and fluid policy agenda requirements that are constitutive of the three types of dependence theorized to lead to regulators' intervening in the market for corporate control.

The fourth is a static empirical observation but a hoop test for the theory: the underlying conditions that describe dependence must be empirically observable for them to have causal effect. These are powerful and necessary observations: they overcome some of the inherent inferential limitations associated with statements by informed observers and participants, because they ground those statements in observable facts that are consistent with the predicted claims of observers and participants, as well as the predicted conditions under which those claims would be made (i.e., dependence to provide critical infrastructure, oversee market conduct, or deliver on policy agenda items).

*O4: Historical policy developments that have led to a) centralized regulatory authority in a single public body; b) a minimal degree of self-regulation by firms; c) competitive market structures; d) a lack of vertical integration by exchanges will be strongly and positively correlated with regulatory opposition to exchange mergers (and vice versa).*

If the theory of regulator dependence is valid for these cases, we should expect to observe several of the following:

- Where a merger is blocked, historical processes and policy decisions:
  - Allocating regulatory authority to the exchange firm
  - Allocating regulatory authority over the exchange firm across multiple public bodies

- Producing or maintaining a monopolistic or oligopolistic market structure
- Enabling the vertical and horizontal integration of multiple exchange industry firms in a single firm

These antecedent policy developments about the allocation of regulatory authority in the exchange industry and the structure of the exchange market are necessary conditions for regulator dependence to be observed. The allocation of regulatory authority to the exchange firm as well as the allocation of responsibility for market outcomes across multiple public actors create a matrix of regulator dependences on the firm for the development, implementation, and monitoring of market rules, both in terms of the degree to which exchange firms have power over those rules and the sheer number of public office-holders for whom that power over rules is relevant. The allocation of regulatory authority thus has direct and positive impacts on each of the three types of dependency theorized to exist: for the effective provision of critical market structure (i.e., the rules that make infrastructure useful and effective for market participants), the determination of private conduct in the market, and the execution of time-dependent policy agenda priorities with a rule-based dimension.

Similarly, market structure developments enabling a concentrated market structure with a sole (or few) provider(s), as well as the concentration of multiple market services (trading in multiple assets categories as well as providing post-trading services) within a single firm, also lead to a matrix of regulatory dependencies (and especially in conjunction with the first set of observations regarding the allocation of authority). First, officials cannot turn to other firms to provide services and, second, they may be dependent on the firm to provide not just one but multiple types of services. The observation of these historical policy processes and outcomes means that two of the three dependencies theorized to motivate regulators to block cross-border

mergers is likely to exist: for the provision of market infrastructures and for the provision of market-side policy agenda execution. The last – dependence for market conduct outcomes – may exist where post-clearing services are integrated into the exchange firm, thus creating powerful dependencies regarding market participants' management of systemic risk.

In short, as a result of these antecedent policy decisions, regulators are theorized to become dependent on the firm in at least one of the three ways identified by the theory, and thus care deeply about the increased costs involved in overseeing a cross-border firm. If these antecedent policy decisions cannot be observed – or if they are inconsistent with the predictions of the theory – then there may well be other causes of regulators' dependence on market-side players and overall approach to mergers (i.e., ideational, systemic, or societal, rather than historical-institutional in origin).

Where a merger is allowed, historical processes and policy decisions:

- Concentrating regulatory authority in the state
  - Concentrating regulatory authority over the exchange firm across small numbers of public bodies
  - Enabling competition
  - Refusing or discouraging the vertical and horizontal integration of multiple exchange industry firms in a single firm

Similar to O1, these antecedent policy conditions are expected where regulators allow cross-border mergers involving exchange firms, and they are necessary conditions for the observation that regulators do not interfere in merger proposals. These historical policy outputs reduce regulatory dependency on the firm and thus reduce the material implications to regulators of the increased costs of overseeing a cross-border firm. Where regulators do not depend on

market firms to develop, implement, and police market rules, and/or only small numbers of public officials are statutorily responsible for market outcomes, then the implications of a cross-border merger are less significant. Regulators will not worry about their reduced influence over exchanges' rulemaking and implementation – and the impacts on the provision of infrastructure, oversight over market conduct, or the delivery of policy items – if the authority to make materially significant rules is held by the state; and similarly, fewer numbers of regulators worrying about that reduced influence lessens the overall level of public dependency. The same is true of market structure developments. If, for reasons of historical competition policy choices, the exchange is only one of multiple venues and/or is not a node for the provision of multiple critical infrastructure services, then it is not likely that regulators will be highly dependent on the firm for the delivery of any particular market services, the oversight of market conduct, or the execution of any discrete policy priorities.

This historical process assessment is, broadly, a hoop test for the theory: it must be possible to trace regulators' decision-making on cross-border mergers to historical processes and policy outputs about the allocation of regulatory authority and structure of the exchange market. If decisions on merger proposals cannot be traced to at least some – and ideally all – of these antecedent processes and policy outputs, then the theorized causes of dependence are invalid and another explanation for the presence of regulator dependence must be sought.

The dissertation now turns to the empirical tests of the theory.

## **CHAPTER V**

### **TORONTO-LONDON: A STATIC TEST OF THE THEORY OF REGULATOR DEPENDENCE**

#### **Introduction**

On Feb 9, 2011, Canada's TMX Group Inc. and the London Stock Exchange's parent, LSX Group PLX, announced a "merger of equals", albeit one executed via a public share swap that would leave LSX shareholders with 55% of the shares in the company. Almost immediately, many members of the Toronto financial community – including four of the country's largest banks and the Ontario finance minister– voiced public concerns about the implications of the merger for the Canadian financial sector, concerns that were countered by other high profile Canadian institutions in favour of the deal. Eventually, a thirteen-member coalition of Canadian banks, pension funds, and private equity funds formed a coalition, the Maple Consortium and made a counter offer that also included acquisition of the Toronto Stock Exchange's main competitor (Alpha) and the equities clearinghouse CDS, on top of TSX, Montreal Exchange, TSX Venture Exchange, and Canadian Derivatives and Clearing Corporation (all four owned by TMX). In June 2011 the LSE proposed was defeated by shareholders. The Maple transaction was approved by both shareholders and regulators in the summer of 2012.

This first chapter provides a static test of the theory's predictions. The Canadian case in particular – i.e., the negative reaction to the merger observed on the part of critical Canadian regulatory authorities – is a complex empirical story to untangle but the test it provides of the theory is relatively straightforward, inasmuch as the conditions for dependence are rather

obvious in the Canadian case – the TMX is a monopolistic and multipurpose firm with substantial regulatory capacities and is implicated in important regulatory projects. As a result, if the theory has empirical tractability it will be possible to a) show that regulatory actors were responsible for the commercial outcome observed here; b) directly trace the dependencies just described to the merger outcome; and c) demonstrate their lineage in historical policy decisions relating to market structure and regulatory authority.

This chapter demonstrates clearly that the counteroffer was driven to a significant degree by support from Canadian regulators, both in terms of coordination as well as steering investor sentiment away from the London deal. The chapter also demonstrates that in the UK, British authorities did not express any of the same concerns. Why did Canadian authorities intervene – albeit non-publicly – in the proposed merger between TMX and LSE? Why did the British fail to do so? This chapter shows that, unlike their British counterparts, Canadian authorities required the compliance of TMX to achieve many public policy goals: officials across Canada are dependent on TMX and three of its component parts for the execution of their policy agenda, particularly (but not exclusively) at the time the merger was proposed. As the case shows, those authorities had the capacity to interfere in the deal – in this case, informally and through public-private policy networks, where a willing alternative group of Canadian investors was found and cobbled together. Most importantly, the case demonstrates that the decision to act in this manner was a direct result of historical policy decisions regarding the structure and public oversight of Canada’s capital markets. The chapter also includes a brief shadow analysis of the Australian-Singaporean tie-up between ASX and SGX that was blocked by the Australian government, and shows that the very same causal logic obtains in that case.

## **The Toronto-London merger proposal**

### **The insulation of the Canadian regulatory response**

First, it is necessary to provide process evidence that corroborates the claim that Canadian regulators acted on the basis of their own insulated preferences – rather than as a result of social pressure – to maintain exclusively Canadian control over a key piece of market infrastructure.

The key observations here are twofold. First, political office holders, while engaged in the merger process, were split in terms of their support or opposition to the merger, and were either powerless with regards to the final merger outcome or did not exercise the powers that they had. The result is that it is difficult to see how public/electoral pressures directly influenced the outcome via the regulatory authorities whose actions led more directly to the merger falling apart. Second, the Canadian financial industry was itself torn down the middle in terms of its preferences for this deal, meaning that it is inferentially challenging to ascribe a significant causal role to some set of private sector preferences, but not others. In short, electioneering and lobbying are not efficient explanations of this merger outcome. This does not mean that those pressures were absent, but that they cannot on their own explain the observed outcome.

It is important to foreground that the very fact that Maple's counter-offer was successful meant that both the interest and the statutory authority of politicians to block the deal was not tested. In particular, the Canadian federal government's "net benefit" test under the Investment Canada Act was considered but not invoked, because the deal was blocked and the counteroffer was settled via commercial channels. The Industry minister at the time, Tony Clement, assured Canadians that the government would take the appropriate steps to review the deal but the extent to which his ministry began its assessment and even the grounds upon which any preliminary

federal analysis was undertaken are not publicly available, and interview subjects were unwilling or unable to comment on this detail – although one did note that the Finance Minister at the time, Jim Flaherty, was understood to be privately concerned about the merger (Anonymous Interview, Ottawa, January 18, 2013). However, it is clear that the federal government did not publicly intone in any detail on the Maple-LSE deal, taking a much more reserved line – which was simply that they would analyse and consider options in due course. How they might have proceeded is simply not known.

Within the political sphere, the greatest degree of public concern came from the Ontario government, and particularly its finance minister at the time, Dwight Duncan, who came out publicly and loudly against the deal. In doing so he broke with his counterparts in Western Canada, as senior politicians in Saskatchewan, Alberta, and British Columbia voiced their support, while Quebec expressed more tepid reservations and, as noted, the Federal government promised a review. Duncan went so far as to call the TSX a “strategic asset”, arguing that “we have to take into account not just the shareholders of the TSX and the LSE, but we have to take into account the shareholders of Canada, the people of this country” in considering the long-term implications of the merger (Canadian Press, 2011). Duncan focused on the loss of control over that asset: in his words, “No. 1, control will rest offshore; No. 2, once you sell an asset like this, it's pretty darn difficult to get it back” (Howlett, 2011a).

Duncan was not only isolated nationally, in terms of the degree and tenor of his opposition to the deal – i.e., compared to the other provincial governments and the more publicly circumspect federal government. He was also not able to drive any kind of consensus within Ontario itself. The Ontario legislature quickly convened a Select Committee to hold hearings and consider the implications of the mergers. The hearings themselves are very useful as a

window into the myriad opinions and perspectives that emerged in Toronto and beyond regarding the merits of the deal. These are discussed immediately below. However, the lack of political consensus that emerged in those hearings is reflected in the final Committee report, which expressed reserved support for the merger on the part of the Ontario legislature, with the dissent of the left-leaning New Democratic members of the Committee (who were, significantly, not members of Duncan’s governing Liberal party).

Furthermore, it is crucial to understand that Duncan, as the strongest political voice in opposition to the merger, was not only a relatively isolated political voice on the Canadian landscape and in no way backed by a broad coalition – he also lacked the statutory authority to block the merger at all. In particular, no political office holders within the Ontario government – be it the legislature or the finance minister – had the capacity to directly intervene. The Select Committee was in fact the public review option chosen by Duncan upon being advised by his bureaucrats that his office had no legal grounds upon which to intervene in the merger under the Investment Canada Act, or given the other limited powers available to provincial authorities in such matters (Anonymous Interview, Toronto, October 31, 2012). Furthermore, given the lack of legal and regulatory tools available to his office and despite his strong personal reservations, Duncan assured the UK government that the Ontario government would not – in his own words – “strictly kill a deal with the LSE on purely political grounds, that there are no regulatory hurdles [from the Ontario government]” (Howlett, 2011b).

Given his limited options, the public expression of concern was a valid political option for Duncan to pursue, and given the timing of a subsequent Ontario election (in 2011) it may have been an important strategic piece of political posturing: a poll conducted by the Toronto-based Globe and Mail newspaper indeed showed that, when asked, a majority agreed with

Duncan that the TMX was a ‘strategic asset’ (Simon, 2011b). But because Duncan’s opposition was ‘stickless’ and did not have any legal or regulatory powers to back it up, it alone cannot satisfactorily explain the ultimate chain of events that led to the merger with London failing. Duncan himself was clear on this point as the TMX-LSE deal fell apart, stating that “this is the kind of response that I had hoped would come from the private sector. We would not have been able to, just because we didn’t want to allow it to happen, stop it” (Erman and Howlett, 2011), thereby suggesting that the LSE deal’s failure, while political, was in his view not a direct result of his government’s opposition. In short, even where it might most be expected – in the loud opposing force of the Ontario Finance Ministry – any direct political office-holder’s veto over the deal is simply not possible to observe, making it difficult to infer that public opinion or electoral politics were direct causal factors in this case.

Second, private sector influence on the final outcome is similarly difficult to isolate for its causal effects, for the similar reason that private sector interests were disunited in their preferences. It is therefore difficult to ascribe causal weight to lobbying and PR activities when those efforts carried a number of different opinions forward.

Both sides in the policy debate carried out their lobbying activities in both private and public arenas, notably through a number of open letters (Erman et al., 2011a). Senior managers from the exchanges themselves were active proponents of the deal, and actively lobbied Canadian officials to approve the deal. As mentioned above, the exchanges had success at the political level in Western Canada, achieving buy-in from the provincial governments of BC, Alberta, and Saskatchewan, while failing to do the same in Ontario (Simon, 2011c). (The arms-length provincial securities regulators in each of these provinces were more circumspect, and this is analysed in greater detail below.)

While the two merging exchanges were unsurprisingly united in their support for their proposal, the Canadian financial services industry showed fascinating divisions – particularly the Canadian banking sector (Simon, 2011a). Toronto-Dominion (TD), Canadian Imperial Bank of Commerce (CIBC), National, and the Bank of Nova Scotia (Scotia) opposed the deal (and eventually joining the Maple counter-offer consortium), and Royal Bank of Canada (RBC) and the Bank of Montreal (BMO) supported it. Scotiabank was more careful in hedging at first, arguing that further consideration of Canadian governance over the merged group was needed (Tait, 2011). This split is in itself interesting, not least because it points to the complexity of the incentive structures pressuring large multifaceted financial institutions. This incentive structure includes many conflicts of interest: RBC and BMO were brought on as advisors for LSE and TMX, and many of the large banks had ownership stakes in the TMX’s biggest electronic competitor, Alpha. It could be argued that the support or opposition of the banks for the merger proposal reflected these ulterior calculations. As one careful analyst noted, however, RBC and BMO’s support for a merger that they would have otherwise opposed for the sake of an advisor’s fee would be surprisingly myopic; and the theory that opposition to the deal was purely commercial because of the banks’ support for the competing Alpha trading platform does not survive closer inspection, as Alpha’s two biggest supporters, TD and RBC, came down differently on the merger (Erman, 2011). Whatever the deeper explanation for the banks’ various positions on the deal, it is clear that they were divided – making explanations for regulatory outcomes that are based on the structural power of large financial institutions difficult to apply in this case.

These divisions carried down beyond the banking sector, too. While most of the large Canadian pension funds were in support of the deal (Perkins, 2011) much of the rest of corporate

Canada and, within the capital markets itself, large asset managers and brokering firms as well as other buy-side entities were as divided as the banks. In the Ontario Select Committee proceedings it became clear that large lobbying organizations like the Investment Industry Association of Canada, the Canadian Council of Chief Executives, the Investment Industry Regulatory Organization of Canada, and the Toronto Financial Services Alliance were all unable to express a strong opinion on behalf of their membership, due to divided opinions therein.

For example, The Toronto Financial Services Alliance's membership was divided on whether Toronto would prosper as a part of a merged entity, but at least some members shared the sceptical view proffered by the banks aligned against the deal:

Generally, a majority [of our membership] believed that the proposed merger – if its benefits are realized – offers strong potential to strengthen and grow the Toronto region's financial services sector. Clients of the exchange welcomed the possibility of lower fees and improved services if the deal goes through. They also expressed concern that Toronto will be left behind in an era of exchange consolidation. However, others are passionately concerned that this deal is the wrong deal and that it threatens to diminish our role as a global hub. (Legislative Assembly of Ontario, 2011a, pp. 60-62)

Whatever the outcome, the TFSA was adamant that the TSX and TSX Venture Exchange should “be allowed to stay focused on their traditional strengths in resources and in financing for SMEs” (p. 60).

The Investment Industry Association of Canada stated that it supports “global integration and consolidation of markets in principle, as this should, in theory, improve access to and reduce the cost of capital for listed companies. This should also offer the opportunity for lower transaction costs.” But uncertainty about the merger's impact on Toronto's model, and control

over that model, also led the IIAC to express many concerns: Does the transaction grow Canadian capital markets or detract from them? Does it support or impede capital raising activities? Does it help small issuers and small-caps? Will costs and fees go up as a result of the merger? Will regulatory control be surrendered? IIAC expressed concern that trading and financial activity, with its knock-on effects on industry employment, would shift to London, and that new technological expertise would not be developed in Toronto. It worried that a market downturn or a non-realization of the anticipated cost synergies could lead to a ‘rationalization’ to Toronto’s detriment (pp. 50-53).

What this discussion has aimed to demonstrate, then, is that neither officials holding public office with electoral incentives, nor private sector entities with material interests in the success of one outcome or the other, had a clear set of political objectives or even material capacities for influence regarding this merger – making it difficult to state with certainty the degree to which they were influential in shaping the ultimate outcome.

That being said, it is clear that public sector influence emerged to push the London bid towards failure. Interviews conducted in Ontario and Quebec over 2012-2013 confirmed a large public role in the coordination of the alternative, made-in-Canada Maple proposal. It is notable that in these interviews, stakeholders repeatedly pointed out that the Maple deal only worked because the counter-bidding consortium members saw a true value proposition in the TMX acquisition – i.e., it was a viable commercial opportunity (cf. Erman et al., 2011b) (Anonymous Interviews, Toronto, 7 December 2013; Ottawa, 18 January 2013). But that commercial impetus coincided with the wish of key public sector actors – particularly, as the rest of this case study demonstrates, regulatory actors including the provincial securities regulators and, critically, the Bank of Canada. Behind the scenes, officials at the federal level and in the

provinces made phone calls, sought likeminded public and private decision-makers, and coordinated in support of the Maple counteroffer.

Crucially, a small number of interviewees who were willing to speak on condition of anonymity outlined a deliberate choice made by key officials at the federal level – driven by concerns about oversight and management – to tacitly interfere in the market for corporate control. They did so, in one particularly subtle example, through carefully considered public statements suggesting that the Maple counteroffer (subject to competition concerns) was more likely to receive regulatory approval than the London offer (subject to foreign investment review), which thereby tilted shareholder sentiment towards Maple. For instance, an interview then-Bank of Canada governor Mark Carney gave to the Wall Street Journal in July 2011, in which he expressed concern about having the “tools” to supervise clearing and settlement, is a key example of this subtle – but highly effective – interference. The initial choice had been the Canadian Minister of Finance Jim Flaherty, who was also understood to oppose the merger, but it was ultimately decided that his involvement would be too political and Carney was instead convinced that the stakes were high enough that it was necessary for him to get involved. The deliberateness of this strategy was outlined by one anonymous participant in the process:

The big mistake the LSE made was setting the end of June deadline. What we did was convince [then-Canadian Finance Minister Jim] Flaherty to say something to scare shareholders, and create uncertainty that it [the London deal] wasn't going to happen. [Bank of Canada Governor Mark] Carney said it. He was persuaded to say it. He nixed the deal - he scared investors enough that there was regulatory uncertainty that they didn't give the necessary two thirds to approve. (Anonymous Interview, Ottawa, 18 January 2013)

Subsequent developments in the approval process for the Maple counteroffer corroborate this claim: after initially signalling its concern with the Maple deal, the federal Competition Bureau took a back seat, and the Ontario and Quebec securities regulators conducted hearings and subsequently developed the rules and conditions related to approval for the Canadian consortium's takeover – an unusual lead role for market authorities rather than competition authorities to have, given the clear market structure implications of the deal. Those same interviewees confirmed that this coordination between the competition and market authorities was difficult, but that it was informally enforced by outside officials in positions of power in order to ensure the success of the Maple transaction (Anonymous Interview, Ottawa, 18 January 2013). As one Ontario official put it, “the fix was in” on the Maple takeover (Anonymous Interview, Toronto, February 1, 2013). Another insider to the transaction outlined the stark choice that was presented to TMX shareholders as a result of the increasing politicization of the deal. “At the end of the day this became a battle between the value of what was on offer, and certainty about the deal going through. So, Industry Canada - which seemed like a 'surer bet' on the London deal, vs. the Competition Commissioner, which was much tougher due to competition/monopoly/concentration concerns” (Anonymous Interview, Toronto, 7 December 2012). As those competition concerns receded as a result of direct political pressure on the competition authority, shareholder sentiment – and the ultimate decision to go with Maple rather than London – changed in kind.

This alternative explanation, in which interference in the merger was driven by actors with oversight and regulatory concerns behind the scenes, is in need of further development. Why did Canadian authorities intervene – albeit non-publicly – in the proposed merger between TMX and LSEG? And, going even deeper, why did the British fail to do so?

## **Concerns about the costs of regulating a cross-border firm**

In Canada, market authorities expressed a clear set of concerns relating to the complexity and feasibility of oversight, in particular that supervising TMX and enforcing compliance with their regulatory requirements and preferences would be more difficult to achieve with a cross-border management structure in place. These concerns are indeed consistent with the general transaction costs problem faced by financial market authorities – that the cost of achieving a private entity’s compliance is greater for authorities dealing with a cross-border entity than a domestically-contained one.

In interviews, authorities who would not go on the record with their views on how the Maple transaction came to pass (detailed above) nevertheless often pointed to their worries that TMX would be more difficult to oversee and authorities would have less influence over market activities and structure. In short, both formal and informal compliance would be more difficult to achieve in a merged context, in the minds of many stakeholders and policymakers.

How did these concerns manifest at a high level? According to one former Ontario government official, concerns about control over the merged firm, and the ability to shape its role underpinning Canada’s public capital markets, emerged at high levels in both the public and private sectors. “The head office, the keys to the city would be in the City [of London]. At the end of the day it’s a takeover, so this is about control.” Canadian authorities would lose the ability to “just pick up the phone, get access: you need to play with these people on the schoolyard at recess” (Anonymous Interview, Toronto, November 9, 2012). This type of sentiment, albeit short on the precise mechanisms by which control would become more difficult, was constantly observed among stakeholders. Another former official noted that

“The current system is based on moral suasion. Which is, I don't want you to do something, but it isn't illegal, I can't point to anything in the regulations that says 'don't do that', but I really don't want you to do that. But I can use other levers - I can make things happen in other ways you might not like. Moral suasion works really well when the bulk of the business, and the true mind and management of the firm is in the jurisdiction - but not when it's offshore.” (Anonymous Interview, Toronto, February 1, 2013)

Another anonymous official remarked that the deal itself may or may not have been the catalyst driving the concerns that regulators had about their ability to oversee TMX, but that at a more general level those concerns were emerging as Canadian financial service firms' cross-border activities were increasing in nature: “LSE did not spearhead the concerns - they would have been there independently of this deal - onshore/offshore was a major concern in the banks' mind in terms of not having oversight over a core market” (Anonymous Interview, Ottawa, April 2, 2013).

These quotes point to the general salience of the concerns regulators had about complexity, access, and leverage. Furthermore, there is evidence that broader issues related to the governance of cross-border transactions and entities was playing on the mind of key officials at this juncture, a context in which the TMX-LSE merger proposal would have reasonably led to raised eyebrows. But further detail is necessary, not least because these increased compliance costs are not theorized to be unique to the Canadian case; they represent a shared problem for officials across merger proposals. So while this initial evidence supports the claim that the costs of compliance are salient in a merger proposal, they do not explain why Canadian authorities intervened in this deal, where in other cases that intervention has not taken place. Why, then,

were the increased costs of generating and maintaining compliance with public policy objectives significant enough in the Canadian case that the merger was blocked?

**Dependency: how would regulators be affected on the job?**

The reason why, in the Canadian case, regulators stepped in to interfere with the merger is that the costs would have become significant impediments to their ability to do their jobs effectively. Canadian officials required the compliance of TMX to achieve certain public policy goals, or execute items on their agenda: Canadian regulators are dependent on TMX and its component parts for that agenda-execution, i.e. their dependence can be observed 1) on the Toronto Stock Exchange; 2) on the Montreal Exchange; 3) on the TSX Venture Exchange; and 4) on the Canadian Derivatives Clearing Corporation. Each of these four dependencies contributed to the public response to the merger, with the fourth in particular proving to be a major catalyst for public intervention, and indeed appears to have been the primary cause of the outcome in this case.

First, officials at the provincial and federal levels across Canada are dependent on the Toronto Stock Exchange to a) operate a primary cash market for liquid stocks, as the most notable primary equities exchange in the country, b) ensure market soundness as a self-regulating body with some key duties, particularly regarding listed firm and market integrity, and most importantly, c) provide the anchor for Canadian capital market specialization in mining and resources.

The Toronto Stock Exchange was both the central piece of the merger and the most publicly-recognizable component of the TMX conglomerate. In the Canadian equities trading space, the TSX is dominant. Equity volumes from 2011 form a clear contrast with the NYSE

example. ‘Lit’ order-book based trades (i.e., on public exchanges and away from ‘dark pools’ of liquidity) accounted for between 85% and 93% of total Canadian equities volume in 2011 – and each month, the TSX varied between 36% and 46% of that total volume. Its nearest competitor, the Alpha exchange, never took more than 15% of the total (Thomson Reuters, 2014).

Turnover statistics point more clearly to the central role of the TSX in the Canadian equities marketplace, and as a provider of public goods. Turnover – a measure of the liquidity of stocks, calculated by dividing total available stock by volume – is dominated by the TSX in 2011, with between 62% and 68% of the monthly Canadian lit order book turnover in equities (Thomson Reuters, 2014). Clearly, by this measure, TSX’s marketplace is the most liquid grouping of stocks, and TSX is more likely to be used by market participants looking to execute trades than its competitors. It is both the most important venue for listings as well as for trade execution, and the primary marketplace for Canadian blue chips as well as home to many large and medium-sized resource firms. It continues to be the largest venue for stocks that are valuable to institutional investors as stores of value as well as familiar to retail investors playing the markets. On each of these important items it remains unrivalled in Canada, despite efforts by authorities to encourage competition in the equities execution space.

The result is that the TSX is uniquely positioned to provide many public goods on which market participants depend, including price discovery, due to the liquidity in its cash market. Crucially, the TSX has a role in establishing market integrity and transparency standards not just through its application of public law but also through its Rulebook, which establishes rules for trading; the Rulebook also delivers a standard of corporate governance through its listing rules. The provenance of this exchange-held capacity is detailed below, but its significance is

immediately clear in that it means that private decisions by the exchange have a direct impact on both the types of transactions that are possible and the rules that govern those transactions.

An insider in the TMX-LSE perspective explained that, from a trading perspective, there was concern “on the street” (i.e., in the trading community) that the people who trade in Canada in significant volumes, for instance institutional investors and banks’ proprietary and client trading arms, would lose their ability to influence trading rule decisions. Indeed, the same insider explained some aspects of Canadian trading rules are unique from US and UK rules, in ways that reflect the particular market dynamics (for instance the types of participants and the liquidity of certain asset classes) that are in place in Canada. In many cases these rules are tailored to the specific needs of the mining industry and the institutional investor community in Canada. So the concern on the street in some trading camps was about losing influence over rules made at the level of the exchange – i.e., over the rules for trading that are made in and for Toronto (Anonymous Interview, telephone, March 29, 2013). Moreover, these private sector concerns should not be seen as totally removed from the concerns of officials. As argued in previous chapters, to the extent that exchange firms are able to set their own rules regarding market microstructure, this reflects an appreciation on the part of officials that proximity to the market allows experts within those firms to design rules under a broader umbrella of public securities law that are appropriately tailored to the market(s) in question. An exchange firm that is no longer as connected or responsive to a domestic trading ecosystem is, for regulators as much as for private firms, a potential threat to the overall health of that ecosystem, and thus a threat to the market-preserving and enhancing mandate of securities regulators.

Indeed, and in the same vein, there is a broader aspect to the TSX’s role in the Canadian markets that generates dependence for public officials: not only as Canada’s major self-

regulating cash exchange, consolidating liquidity and stable investment opportunities on a scale unmatched in Canada (with a market share that is unmatched by incumbent exchanges in many other major jurisdictions); but also as the anchor of a capital market built up around a particular specialization in mining and resources, and a market that is populated a large number of experts and intermediaries who have built specific assets tied to that market niche. As a politically-connected individual involved in the deal explained,

“Consider that the mining sector, globally, looks to Toronto - London wanted it for this reason – and unlike Potash, the oil sands, in which people can't move the resource abroad (i.e., the jobs won't be lost except some head office jobs), in financial transacting once it's sold the jobs don't have to remain here.” (Anonymous Interview, Ottawa, January 18, 2013)

According to the TMX's public data, fully 56% of the world's publicly-traded mining companies trade on either the TSX or the junior Venture exchange: more oil and gas companies trade on the two exchanges than on the NYSE and London Stock Exchange combined. While the world's largest blue-chip resource companies tend to trade in London, the fact remains that the Toronto market is home to a disproportionate level of expertise and transacting involving mining, oil, and gas firms, compared to other marketplaces. The TSX's 'Technical Guide to Listing' includes chapters dedicated to the 'special considerations' and instruments required by mining (see its Chapter 6) and oil and gas (see its Chapter 7) companies – its listing rules have special dispensations catered to the unique disclosure and capital dynamics in those markets, particularly relating to resource discovery and development. The TSX's unique role underpinning the mining and resource sectors was indeed noted multiple times by both public and private stakeholders at the Ontario Select Committee, and in its final report, the Committee's

ninth recommendation sought guaranteed firm undertakings “to preserve the role of TMX Group as the global leader in equity financing for the mining sector”, to be monitored and enforced by the OSC (Legislative Assembly of Ontario 2011b, 17). Critically, in an interview OSC officials (speaking as individuals) noted the unique liquidity dynamics in a tailored market like Toronto’s, and acknowledged that the merger prompted concerns about whether a large-market regulator (the UK’s then-FSA) would understand how to oversee such a market. These broader market-provision concerns – and whether a merged firm would continue to do so in a manner that satisfied Canadian market authorities – were clearly a large and looming concern (Interview with OSC officials, Toronto, December 7, 2012).

Second, officials in Quebec, as well as macro-prudential officials at the federal level, depend on the Montreal Exchange as the only Canadian venue for exchange-traded derivatives (ETDs). What value does a derivatives marketplace hold for public officials – what do they need it to do?

While the exchange accounts for only a small fraction of Canadian derivatives traffic (the rest being bilateral and ‘over-the-counter’ rather than exchange-traded), ETDs are in favour with policymakers as a transparent, liquid, and standardized alternative to OTC derivatives (G20, 2009). Moreover, ETDs can also assist in the pricing of bonds and other assets tied to the price of sovereign debt and the management of the public purse: this is a very important role from the perspective of macro-prudential and monetary policymakers. For this reason, as one senior executive noted closely connected to the Maple transaction noted, regulators want to ensure that the Canadian derivatives exchange is well-resourced and appropriately run - they "don't want it to get swallowed up - say by [Atlanta-based] Intercontinental Exchange, which [also] wanted to buy MX... If you're the Bank of Canada, you look at the pricing for your interest rate products -

you depend on MX for pricing... you need liquidity and volume” (Anonymous Interview, Montreal, March 7, 2013). Again, much as in the TMX case, the ongoing provision of this activity in a manner that is helpful for Canadian authorities requires that the exchange is properly run in accordance with Canadian rules and standards. More importantly, it requires that Canadian dollar denominated interest rate derivatives remain a viable and liquid asset class in the exchange-traded environment, which, in all likelihood, requires a Canadian exchange with large Canada-based institutions trading in those products.

What is more, in Quebec as in Ontario, officials see the MX as a key component of Montreal’s financial sector – and many observers attested that the Quebec regulator has a (tacit) mandate to worry about the continued viability of that sector and the jobs associated with it, as well as market integrity. From this point of view, the global integration of the exchange threatened the local financial sector, particularly because of the dependence on the MX to anchor it. A former federal official explained it as follows:

Montreal would be the world headquarters for derivatives. But, we might have to rescale if we acquired new properties or new business lines down the road. And there was a 5-year sunset clause in the agreement. So, CDCC (the Montreal-based derivatives clearinghouse) would be the derivatives clearinghouse, Montreal would have been world HQ for a nanosecond. 5 months after this deal LSE made a bid for [London-based] LCH Clearnet, the world’s largest interest rate derivatives clearing house]- it’s 200 times the size of CDCC, and it would have had the business. The 'Head of Derivatives Trading' would have been in Canada. What does that mean? It’s a title. Canada would have so many heads, so many titles, but that could change as the organization grew and changed. The

provisions are designed to lapse - sunset clauses are in there because people intend to use them. (Anonymous Interview, Toronto, February 1, 2013)

Not only the commercial energy, but also the things that officials require that commercial energy to lead to (namely, the pricing of Canadian debt and dollar-based assets) were seen as both less viable under a cross-border entity, and certainly more difficult for officials to appropriately steer and control. This dynamic emerges again in the fourth dependency, below.

Third, officials at the provincial and federal levels across Canada are dependent on the TSX Venture Exchange to provide the main financing mechanism in Canada for junior and mid-cap firms, and to contribute to Canadian capital market strength in mining and resources. The TSX Venture Exchange, headquartered in Vancouver, plays a unique and significant role in the Canadian capital markets – and not only because of its substantial share of total equities volume in Canada. It is the only market in Canada regulated to meet the bespoke transparency, disclosure, and capital demands of small and mid-sized firms, particularly in the resource sector. Moreover, it is often and widely regarded as a rare success story in the junior equities marketplace globally – one analysis has referred to it as “the only public venture capital market in the world”, with a success rate for listed firms that is four times greater than the corresponding rate in the private venture capital market, far outstripping the successes of junior markets in London and Europe (Carpentier and Suret, 2010). It is a dominant financing mechanism for Canadian resource sector start-ups and anchors a network of intermediaries with deep knowledge of the resource sector.

Moreover, due to its relationship with the TSX in Toronto, through which junior firms often ‘graduate’ to the Toronto board, the Venture Exchange forms a key component of the Canadian capital market ecosystem for resource firms of all sizes. In 2010, 330 of the 1,474

companies listed on the TSX had graduated from the Venture exchange (Tingle, 2013), which is seven times as many firms as developed through the use of private venture capital (Carpentier and Suret, 2010). Indeed, it is worth noting that MPPs involved in the Ontario legislative committee hearings into the Toronto-London merger asked many questions about the AIM marketplace run by the LSE – a junior marketplace in London with a sometimes-troubled reputation for very light touch regulation (Gerakos et al., 2013) – and worried about the negative impacts joint ownership of those two junior exchanges might have on the TSX Venture.

Importantly, the size and (in)effectiveness of the Canadian private VC market was a salient policy issue at the time of the merger. An expert panel submitted a high-profile review of the federal role in supporting innovation through start-ups in 2011, and the federal government has more recently rolled out a ‘Venture Capital Strategy’ over 2013-2014. New policy goals for the private VC market do not directly implicate the TSX Venture Exchange, but given its unique success – especially compared with the many unsuccessful international attempts to build junior public marketplaces (Posner, 2009a), and the relative paucity of Canadian private venture capital pools compared to the US – it is reasonable that foreign ownership of the Venture became a source of concern to stakeholders and officials seeking to augment capital opportunities for SMEs. This concern is especially reasonable given that the LSE ran a junior market of its own, with substantial self-regulatory powers and an often-ambivalent reputation for quality. For instance, the Toronto Financial Services Alliance – a public-private partnership advocating on behalf of Ontario capital market participants and public stakeholders – was adamant in its public testimony about the merger that the TSX and the Venture Exchange “be allowed to stay focused on their traditional strengths in resources and in financing for SMEs” (Legislative Assembly of Ontario, 2011a, p. 60-62). And in keeping with the concerns noted above about the degree to

which a cross-border firm would attend to parochial concerns about rulemaking, a federal official explained in an interview that, indeed, “London might not be attuned to the needs of the local market, it might seek to merge the Venture exchange with AIM... all these kinds of issues [were concerns]” (Anonymous Interview, Ottawa, April 2, 2013).

Each of these three dependencies was important in terms of creating the general conditions in which authorities were concerned and closely observing both the details and the process of the proposed merger. However, one concern and regulatory authority stands out for its impact on this case.

Fourth, then, and most, prudential regulatory authorities, particularly at the Bank of Canada, were dependent on TMX’s Canadian Derivatives Clearing Corporation as the only central counterparty able to clear derivatives contracts, at a time when the Bank was mooting mandatory on-shore/domestic clearing as part of the G20 reforms to OTC markets. This proved to be the critical dependency.

TMX fully owns the CDCC. In 2011 the Bank of Canada was – like market authorities across the G20 at this time – investigating solutions and policy alternatives for reforming the over-the-counter (OTC) derivatives markets in the wake of the financial crisis. One of the key pillars of this reform is a mandate to ‘centrally clear’ certain standardized categories of OTC derivatives, including interest rate and credit swaps, through central counterparties (CCPs). CCPs are a backstop to securities transactions – they are the buyer and seller of every ‘cleared’ contract, and in that way stand between counterparties in the event of a default of any single counterparty. They thus manage both counterparty risk as well as the impact of a default, through a series of default management procedures that allocate and, in some instances, mutualize the costs of a market crisis. In attempting to apply this mandate to centrally clear

more derivatives, authorities have had to confront an OTC derivatives market that is already highly cross-border in nature. As a result, those same authorities from across the G20 member states have been forced to carefully weigh the pros and cons of a key policy issue: should central clearing be mandated to take place at ‘onshore’ CCPs, or can domestic clearing mandates be fulfilled through the use of large and liquid CCPs elsewhere, in foreign markets? This debate remains unresolved in many jurisdictions.

While complex, at root this issue has to do with the management of systemic risk, and the ability of prudential authorities to have access to the CCP that is most important for their own market (whether onshore or offshore) in the event of a catastrophic default, especially a default requiring ‘extraordinary liquidity’ injections in the form of public bailouts through central bank credit creation. As a result, central bankers and other prudential authorities consider that having a voice in default procedure decision-making – i.e., decisions that have significant distributional consequences for market actors across jurisdictions – is critically important. This is increasingly significant given the potential implications for taxpayers, as well as broader macroeconomic impacts to exchange rates, market liquidity, and fiscal balance sheets.

In this case, the Bank was dependent on TMX in its contemplation of a made-in-Canada solution to the problem of mandatory clearing for OTC derivatives. The TMX-owned CDCC was the only viable option in the country: as a derivatives CCP it was able to provide expertise and capacity regarding the highly-technical rules regarding risk-management and mitigation for the cleared derivatives market. Notably, CDCC, like many CCPs, establishes rules and complex methodologies around margin and collateral collection from its users, in addition to maintaining rigorous membership standards and developing default management procedures (in line with

Canadian bankruptcy rules) on top of its other regulatory obligations. This expertise made it a uniquely valuable institution in the context of the Bank's policy dilemma.

Moreover, the Bank of Canada was simultaneously in the midst of a regulatory effort to authorize and then oversee the clearing of an additional class of fixed income financial instruments, complex repurchase ("repo") contracts, for which it was making use of the CDCC. Now in place, the policy goal behind this mandate at the time was to increase the stability of the Canadian fixed income market – as a result, in April 2012 the Bank established oversight over the CDCC as a systemically important institution subject to Bank oversight under the Payments Clearing and Settlement Act.

As a result of these two significant and then-live policy initiatives, the Bank was dependent on TMX in its contemplation of a made-in-Canada solution, i.e., an 'onshore option'. CDCC was front-of-mind for prudential policymakers at this juncture. In private interviews, both officials and market participants confirmed that the Bank of Canada's concern about its execution of the clearing mandate through CDCC that catalyzed the effort to organize against the LSE's offer. The Bank's preferences to maintain the onshore option through a Canadian-managed CDCC was evident to many insiders. For instance, one attested that "We didn't know how it would land on the clearing of swaps... we felt and the Bank felt that the existing Canadian CCPs should be a part of [the solution] - CDCC and CDS should be wrapped up in it" (Anonymous Interview, Montreal, March 7, 2013).

A former official who had been very close to these technical issues explained in greater detail:

The Bank of Canada was standing up and saying that the piece of the pie they cared about was clearing and settlement. So, CDS and CDCC. If these broke, then the Canadian

financial system would stop functioning. CDS had already been designated a systematically important institution, but CDCC had not been yet. The Bank was in the process of designating it as such, as a part of building a repo clearing house... You have to ask yourself - would it be OK if CDS or CDCC were run out of London? ... What we have to understand is what happens once the cows have left the barn. We can tell the Brits, 'goddammit, spend more on our systematically important infrastructure' - but they'll do what they'll do. These institutions have to work, and work well, one hundred percent of the time. We need to make sure we have the tools to make sure they keep operating - if the tools are not there, can they be put in place? Of course, but in a timeframe that allows the transaction to proceed and makes a difference? Could be 3 years later that the regulations are ready, but the economic rationality, and the firms have moved on. (Anonymous Interview, Toronto, February 1, 2013)

To market side participants who were supportive of the Maple transaction, this was a clear invitation to communicate their overlapping interests in preventing the takeover. As one anonymous Maple insider put it: "We noted that we could solve and resolve the central clearing house problems for regulators... [and] help advance Canada's accomplishment of G20 initiatives". This same insider declared that, in terms of driving the outcome, the Bank and particularly the Bank's concerns with the resolution of the clearing issue was the "whole kit and caboodle" – i.e., the most significant variable to understanding TMX-LSE (Anonymous Interview, Toronto, December 7, 2013).

It is important to note that, in the end, the Bank of Canada did not choose to mandate onshore clearing of OTC derivatives, and instead chose to recognize and oversee global CCPs like London's LCH.Clearnet (Chande, 2012). The economics of building a viable domestic

CCP, when Canadian institutions were already using global CCPs, were not simple not supportive of creating an onshore mandate. However, this does not undercut the causal role of the Bank's concern about control over CDCC. In fact, it adds an additional and fascinating nuance to the argument. The Bank of Canada was worried that, if it allowed offshore clearing, it would not have influence over the resolution and recovery processes for CCPs in foreign jurisdictions in the event of a crisis or default. Multiple interview subjects confirmed that the Bank sought to maintain CDCC's management in Canada in order to hold on to an onshore clearing option, while it simultaneously negotiated through the Financial Stability Board what came to be known as the Four Safeguards for cross-border CCP oversight, through a joint college model – like that now in place for the UK's LCH Clearnet, through which many Canadian banks clear their OTC interest rate contracts and are even members.

As a federal official explained in detail,

[The Bank and others] concluded the costs of maintaining an onshore CCP (not necessarily building one) were sizeable . . . the costs were sufficiently high that it was determined there would be material effects on the viability of Canadian market users to pursue this option. One could conclude from this that we really never had an onshore option . . . but we wanted to preserve that option and continue to repeat it... so that we could get the development of the Safeguards...it was ultimately up to the Bank of Canada to be comfortable with the compromises, through MOUs or whatever, and if not, we could hold out, and mandate the use of onshore clearing houses, which would not benefit LCH and London, its jurisdiction, if we did so....”

But [maintaining control of CDCC and CDS] could be really important for new business ...there are going to be other products, and some of them are going to get

standardized for clearing, and Maple might provide a structure for a Canadian solution to that. (Anonymous Interview, Ottawa, April 2, 2013)

This final source of dependency is thus complex and requires an overview. In the first instance, the Bank of Canada was dependent on a Canadian CCP to even contemplate two policy initiatives it had underway – the onshore clearing of OTC derivatives in line with the G20 mandate, and the changes to the repo market that it was independently pursuing. In both instances, CDCC remaining Canada was consistent with its policy goals, and its joining an international conglomerate was deeply concerning given the oversight and control it was attempting to instil post-crisis.

However, the Bank ultimately shied away from implementing an onshore version of the G20 clearing mandate, and it now allows Canadian firms to clear through offshore CCPs. This does not, however, obviate the significance of the Bank's role in the merger – and indeed, as explained by one official, the Bank actually used the merger episode as leverage to achieve the types of control and oversight that it was concerned it would not have over a CCP it simply allowed to join an international conglomerate.

While perhaps non-linear, the process elaborated here is fully consistent with the proposed theory, in that a regulatory authority acted on its cost-mitigating incentives to preserve domestic control over a piece of infrastructure. Moreover, in doing so, it was able to gain access and influence in an international venue, further reducing the costs of cross-border regulation it faced.

## **The roots of dependency: how Canadian markets got this way**

The final step in this case is to demonstrate that these decisions are a function of historical policy developments, as theorized. How did Canada's securities markets evolve in such a way that its authorities found themselves dependent in these four ways? What put officials in a situation where the behaviour and compliance of market infrastructure firms was absolutely critical for them to achieve policy goals, so much so that an intervention into the market for corporate control was required – especially given that this is not the case in other jurisdictions?

The answer can be found, as expected, in historical processes shaping the statutory allocation of regulatory authority and market structure.

The Canadian case is indeed an apt example of one where outcomes on these issues have directly led to systems of dependency. As an Ontario government official explained, a clear view emerged in response to the merger proposal: “It was the plumbing – TMX was viewed as critical market infrastructure. So, maybe you take a step back from globalization.” The same official further explained how market structure drives this ‘critical infrastructure’ perspective – noting, too, the need for Canadians to retain autonomous decision making as a result: “Maybe the market doesn't have enough competition, but that's something we should be controlling, deciding... we should shape the market” (Anonymous Interview, Toronto, November 9, 2012).

In the Canadian case, there are four important policy outcomes regarding, first, the allocation and structure of regulatory authority, and second, the nature and extent of horizontal and vertical integration in the market infrastructure space.

First, the statutory delegation of regulatory authority to the TMX via self-regulation has the nature of public sector dependence on that firm. As has been noted, the globalization of

capital markets has led to pressure to rationalize and standardize securities regulations, often leading to the state taking a more active role in market governance – largely through the development of arms-length agencies on the US model, with the concomitant removal of club governance or self-regulatory duties from exchange firms (Moran, 1991; Coleman and Underhill, 1995; Lutz, 1998). This trend has been driven, too, by the demutualization of exchanges and the need to address subsequent conflicts-of-interest, especially regarding listing and trading rules that have been traditionally self-regulated (Fleckner, 2006). Canada has been exposed to these forces, like every significant market.

However, unlike the UK where the London Stock Exchange lots nearly all of its self-regulatory capacity to the UKLA in 2000 (discussed below), regulation in Canada followed a trajectory closer to that of the US. Post-demutualization, the TSX and other cash venues in Canada hived off market surveillance and disciplinary proceedings to an independent self-regulating body, the Investment Industry Regulatory Organization of Canada. But even more significantly – and to an extent greater than in the US – the exchange itself has retained the ability to make listing and trading rules through its Rulebook (in consultation with public authorities) – critically important rules that shape daily transactions and underpin the capital markets. These rules are particularly significant for firms in the mining and broader resource sectors that often have different disclosure and transparency requirements than other firms.

This public dependence on the TMX is evidenced further by a key policy decision made at the staff level in the Ontario Securities Commission, a decision that suggests dependence not only on the firm’s decision-making on the Rulebook, but also on TMX’s decision-making on corporate strategy and resource allocation in a manner that is tied up with the exchange’s continued private rulemaking authority and influence. As background, the OSC issues

‘recognition orders’ or exemptions to all trading venues, determining in that process what entities can operate as recognized exchanges in the province of Ontario. Here the OSC has made a deliberate choice to recognize not only the Toronto Stock Exchange, but also the holding company – TMX Group – as an exchange, even though only the former is an actual trading venue, and the TMX Group is its corporate parent only. OSC officials – again, speaking as individuals – explained in an interview that this strategy allowed them “a direct hook into both”, and that while TMX was only responsible for setting the broader corporate strategy, the OSC used the recognition order to “make sure that the operator [TSX] was being funded appropriately for our needs”. This policy decision is based on an appreciation of the formal self-regulatory authority of the exchange, but also on the OSC’s awareness OSC staff that decisions made at the corporate level have substantial implications for how the capital markets operate – how well they operate, who has access to market capital, and how efficient and liquid they are. In short, the formal and informal power of both the exchange (TSX) and its parent (TMX) to make rules was well understood by the OSC, who reacted with an innovative licensing strategy. More broadly, absent these formal and informal powers it is unlikely that the same concerns about ‘hooks’ into the firm would have been triggered (Interview with OSC officials, Toronto, December 7, 2012).

This is demonstrated by the OSC’s enunciation of a key policy concern. The OSC questioned whether their strategy to maintain influence over holding company – level decisions would be less effective – or even impossible – to impose on a management group based in London, severely reducing their leverage. Speaking at the Ontario Select Committee, OSC Chair and CEO Howard Weston allowed that in the context of the merger proposal, the recognition of the holding company was an “area that we need to pursue with the TMX Group, with the holdco, with the LSE . . . Right now, we do regulate the *TMX Group*” (Legislative Assembly of Ontario

2011a, emphasis added). Privately, OSC officials speaking as individuals noted that it would be "a challenge to recognize a UK-based entity as an exchange - what would this do to the market's integrity"? They noted that while the parties were adamant that nothing was going to change, the OSC was concerned that it was going to lose control over the strategic decision-making of the firm: how it allocated capital, what business lines it prioritized and funded, and where it directed activity. To have leverage over these issues, these OSC officials felt, required a 'hook' at the holding company level – only necessary because of their dependence on both the firm and its senior corporate management to make certain types of commercial decisions (Interview with OSC officials, Toronto, December 7, 2012).

Bob Dorrance, speaking on behalf of TD Securities at the Ontario Select Committee, explained the significance of this self-regulating capacity powerfully:

While the [provincial regulators including the] OSC, AMF, ASC, BCSC and others will still play an important part in regulating overall financial markets, the overall holding company, as you well know, will be regulated by the FSA, and they'll oversee the new entity. The ramifications of this need to be fully understood.

It is very important – and I think this is the differentiator – to understand that the TMX is a self-regulatory body. What that has allowed is that it makes the rules and decisions that dictate how stocks get traded in Canada, who gets to list in Canada, who lists on the TSX Vancouver [sic], when they migrate to Toronto, how much they can finance, how many shares they can issue, whether the board of directors is appropriate – all those rules that are part of the fabric of how Canada has developed its financial system. That's the responsibility of the TSX, not of the supervisory commissions. The TSX will now report

to the LSE-TSX. That's where the management will be. (Legislative Assembly of Ontario, 2011b)

The fact that Canadian exchanges have retained significant self-regulatory authority was clearly of real consequence for stakeholders considering the merger. In that vein, it is worth noting here that Canadian clearing houses also benefit from this self-regulatory capacity.

Second, Canada's capital markets are overseen by a decentralized regulatory structure, with regulators located at the provincial level. This system is based on a constitutional division of powers as well as key decisions at particular policy junctures, but has also continued despite the efforts of federal politicians to wrest the power from the provinces. Federal efforts to build a national securities regulator have been building momentum since a 2003 wise person's report strongly recommended it (Canada Minister of Finance, 2005), but those efforts have frequently run up against opposition (most notably from Quebec) as well as substantial constitutional challenges.

Indeed, at about the same time that federal officials were beginning to pursue the federalization of securities market authority, in the wake of the 2003 report, the provincial regulators were formalizing their devolved authority by deepening and formalizing the Canadian Securities Administrators umbrella organization, particularly by signing a joint Memorandum of Understanding in 2004 (Canadian Securities Administrators, 2004). This institutionalized inter-provincial cooperation has had the effect of harmonizing many cross-provincial rules (often through the joint release of notices and proposals), expediting inter-jurisdictional exemptions and 'passporting' arrangements across provincial boundaries, and enabling cooperation on supervision and enforcement. At the same time, the CSA has crystallized the divided competencies and localized policy concerns of the provincial policymakers by simultaneously

making those arrangements more effective (weakening the case for federalization) and institutionalizing the competencies of the sub-federal authorities. More recently, and crucially, in 2011, the Supreme Court upheld that rules governing securities markets, being based in contract, fall under the provincial authority to oversee property and civil rights. This decision effectively blocked pending federal legislation aimed at establishing a national securities regulator. Since then Ontario and BC governments have committed to deepening their operation in coordination with the federal Ministry of Finance, but opposition continues in Alberta and Quebec. It remains a piecemeal approach, and securities regulation at the time of the merger was a wholly decentralized practice.

This has led to a complex matrix of dependencies, in which regulators with local mandates guard and maintain relationships with the key infrastructures that are physically located in their jurisdictions. Whether their mandates call for a focus on market integrity, investor protection, jobs/industrial policy, or (frequently) some combination of those items, the provincial regulators are dependent on the pieces of the Canadian capital market over which they have jurisdiction to help them maintain standards or deliver on key targets. This creates a system in which multiple veto players with multiple political masters are worried about multiple policy agendas – all things being equal, such an institutional set-up is likely to introduce a conservative, system-preserving bias into the Canadian market infrastructural space. This is borne out empirically.

Interviews conducted in Ontario and Quebec in 2012-2013 indeed confirmed that during the London merger bid, officials at the provincial level (particularly in British Columbia, Alberta, and Quebec) expressed a willingness to block the deal if activities and infrastructures were not preserved in their jurisdictions. Notably, this runs contrary to the political support

voiced for the deal by Western Canadian governments, as discussed above. For example, one insider stated that “[The Quebec AMF] were very interested in maintaining jobs, keeping derivatives trading in Montreal – the AMF takes direct orders from the premier” (Anonymous Interview, Ottawa, January 18, 2013). Moreover, another interviewee explained that both public and private sector stakeholders were aware of the risk of the various pieces of TMX – CDCC, MX, TSX, and Venture – being picked off by outsiders seeking marginal value if the London and Maple deals fell through. Overtures of that kind by foreign institutions had already begun, with at least one large American private infrastructure firm making calls into Toronto about a significant piece of the TMX empire (Anonymous Interview, Toronto, February 1, 2013). The experience of the Winnipeg exchange, purchased by US-based ICE in 2007 and largely mothballed as its services were moved to Atlanta, was noted by the same interviewee as an instructive case study for the provincial regulators looking at the deal. These concerns were highly-pertinent at the provincial level. And as noted already, market regulation staff at the OSC – speaking as individuals, not officials – disclosed that they had concerns about whether a foreign regulator such as the UK’s then-FSA would be attuned to the particular liquidity and disclosure dynamics of a smaller and specialized market like Toronto.

The localized concerns emanating from this decentralized system, one marked by regional dependencies, was reinforced by a third set of historical policy conditions regarding market structure. In allowing for a dominant market position for TMX, authorities created the conditions for a dependent relationship at a later date. The crucial decision came in 1999 – this time made by Canada’s competition and market structure authorities. In 1999 the major Canadian financial exchanges agreed to formalize a non-compete agreement, under which they would specialize and develop their particular strengths without worrying about market entry

from the other Canadian infrastructures. Under the agreement the Vancouver and Alberta exchanges merged to form CDNX (later the TSX Venture), specializing in junior equities. The Montreal Exchange gave up its junior equities to CDNX and turned to derivatives, particularly interest rate derivatives – despite the protestations of members of an Advisory Committee set up by Quebec Premier Bernard Landry, who argued that the MX ought to keep its junior equities business to cater to the needs of Quebec companies (Campeau et al., 1999). Finally, Toronto became the ‘big board’ for mature and larger-cap equities.

This decision was not challenged by the federal Competition Bureau despite its clear implications for consumer choice regarding Canada’s securities infrastructure. The Bureau rationalized its decision because of a concurrent push by the Canadian Securities Administrators to remove regulatory barriers to electronic venues, or Alternative Trading Systems (Competition Bureau, 2009), arguing that this would allow for competition to emerge to each of the monopolistic Canadian exchange components (which, notably, did not fully emerge). The non-compete agreement was implemented: officials were comforted by the potential for competition, plus the fact that – as one industry participant noted in an interview – specialization complemented many provincial officials’ wish to promote their local markets. Specialization certainly protected the smaller exchanges from competition.

The CSA’s decision to allow Alternative Trading Systems has been consequential. The move towards trading away from the large incumbents has had an impact on the market in Canada, like in the US and Europe – bid-ask spreads are tighter and trading fees are lower on average, which are key indicators of overall transaction costs lessening in the market. There are alternative trading systems that have taken volume from TSX, albeit nowhere near the incumbent-busting impact that similar reforms in the US and EU have had. But while

competitive regulations have had a substantial effect, the incumbent exchanges also benefitted from the protection afforded by specialization. This is especially true in an industry where liquidity is the biggest comparative advantage any exchange can possess, making it difficult to unseat incumbents benefitting from those natural monopoly effects. Without the other large and liquid exchanges as competitive threats, the consolidation of volume on the major Canadian infrastructures was pronounced – at a time when capital markets were growing around the world (Boisvert and Gaa, 2001, p. 17). In short, the non-compete arrangement led to greater consolidation of activity around the incumbents, despite regulatory changes that were meant to simultaneously drive competition.

The longer-term effect of this regionalization and specialization of securities infrastructure has been a system in which each component is, for the most part, the only institution of its kind in the country: it has further foreclosed on competition while building up a series of dependencies on not only the firm but each of its component parts to deliver the unique, unrivalled services that it is specialized in. The non-compete agreement between the firms most likely to compete with each other has led to one large (TSX) and one junior equities exchange (TSX Venture); one derivatives exchange (MX); one clearing house each for equities (CDS) and derivatives (CDCC); etc. This has certainly exacerbated the system of public dependency at the local level, by ensuring that each of the major securities regulators in Canada (Ontario, Quebec, BC, and Alberta) has a ‘crown jewel’ to guard and depend on for its very *raison d’etre*. But it has also added a federal level of dependence: not only do local officials have incentives to guard their only piece of infrastructure – but that infrastructure is unique nationally, as well, thereby giving federal-level officials incentives to see that each piece is funded and managed

appropriately. As discussed above, this later, federal dependency was critical in shaping the Bank of Canada's opposition to and interference in the proposed merger with London.

The fourth and final policy development that has led to regulator dependence is the public approval for the horizontal and vertical integration of Canada's exchange infrastructure in a single market infrastructure firm.

Vertically, the Montreal Exchange had acquired the Canadian Derivatives Clearing Corporation in 2000, which then became part of the new TMX Group in 2008 when the Toronto-Montreal merger was finalized. On the horizontal side, in 2001, the TSX absorbed the Canadian Venture Exchange, itself a product of the previous consolidation of the Vancouver and Alberta exchanges. TSX then acquired the Montreal Exchange in 2007-2008, despite concerns in Quebec about the transfer of power and jobs to Toronto.

At each stage consolidation was approved and indeed even encouraged by public officials (DeCloet 2007). The federal competition authorities noted that the firms involved in the TSX-MX last tie-up did not offer substitutable products and were therefore unlikely to distort prices under combined ownership – but, of course, this was itself a legacy of the officially-sanctioned non-compete agreement nearly a decade earlier (Competition Bureau, 1999). Perhaps the most significant approval came from the Quebec authorities as the Montreal Exchange was absorbed into TMX – this approval was controversial in Quebec but nevertheless received a pass, and was in fact driven to a significant degree by the federal government and the office of Finance Minister Jim Flaherty in particular (Erman, 2007).

While these market structure approvals had significance when the merger with London was proposed, it is important not to overstate the intentionality or foresight of public actors at these earlier decision points. First, domestic consolidation of exchanges was common across

many markets at this time, particularly because more liberalized global capital markets placed a competitive premium on larger pools of liquidity (as well as the standard synergies to be realized from technology and staff resourcing). Second, the systemic risk and potential market-distorting implications of vertically integrating trading and post-trading infrastructure were not a particularly well-understood policy issue when the MX took over CDCC. In the post-crisis period, the size, ownership, and oversight of CCPs are all issues of serious concern to policymakers. As subsequent case studies demonstrate – particularly the DB-NYX case – market structure issues in the CCP space are increasingly salient, and those markets are being targeted for prospective liberalization. But it is not clear that in either 1999 or 2007-2008, market structure issues relating to the vertical integration of trading and clearing services were yet a subject of substantial regulatory concern.

At the same time, it is highly relevant that CDCC was a part of TMX. First, this is a market space that exhibits considerable variation across cases, as vertical integration between exchanges and clearing houses is not unusual but neither is it the norm. In many jurisdictions and product markets, there are different revenue and ownership models in place, as well as different levels and types of integration into trading infrastructure: in some markets, CCPs compete for product-clearing market share, and in others they are owned and operated on something much closer to a utility model (Bank of International Settlements, 2010). Second, and crucially in this case, the integration of CDCC into TMX meant that in the post-crisis period, a merger involving TMX was going to activate concerns and questions from Canada's prudential regulators, particularly the Bank of Canada.

This is exactly what happened. Not only were market and market structure authorities in multiple provincial jurisdictions implicated because of the horizontal integration of the firm

across Canadian markets; prudential authorities got involved as well, and the interview evidence offered here suggests that those prudential authorities cast the deciding vote regarding the merger. This complex mixture of regulators and regulatory mandates dependent on the TMX, and therefore directly implicated by the merger, turned out to be the crucial dynamic.

These four policy legacies explain Canadian authorities' dependence on the TMX and its component parts for the execution of their mandates.

In sum, then, several important Canadian regulatory authorities determined that their ability to direct TMX and its component parts towards domestically-formulated policy goals critical for them to be able to achieve those goals. Moreover, those authorities had the capacity to interfere in the deal – in this case, informally and through public-private policy networks. Put differently, TMX's cooperation and compliance were judged by Canadian regulators to be required pieces of the public policy execution process at the time the merger was proposed. Public officials were dependent on TMX, and the costs of doing business with TMX in order to get public policies executed could not materially increase, in their view. There were (and are today) neither alternative exchange platforms through which the domestic capital market activities of Canadian business firms could be directed; nor were there alternative post-trading infrastructures that could comprise the on-shore solution to Canada's G20 commitment to over-the-counter derivatives reforms. Finally, these dynamics are based on levels of dependency in the Canadian regulatory environment that are the direct result of previous policy developments shaping the oversight and structure of the Canadian market.

## **The view from London**

On the other side of the Atlantic, British authorities did not evince any particular concern with the deal, and made no moves to ensure that the LSE remained an exclusively British-owned and operated institution. Why?

It is important, first, to note that the structure of the deal itself made it unlikely to raise major concerns among British officials. As the senior partner in the merger and the larger entity of by every important market measure (including capitalization, volume, and capitalization of listed firms), as well as an entity located in a much larger and deeper capital market, London was unlikely to cede power, influence, and volume to Canada. As a UK Treasury official stated in an interview, London is at “the other end of the microscope” when it comes to merger proposals, as a premier market that attracts transactions and decision-makers (Anonymous Interview, London, June 21, 2013). Sunset clauses and corporate governance arrangements were designed to placate Canadian authorities worried about control, not the UK’s FSA or other public officials. In terms of structuring the public response, it would have been easy for the merging exchanges to portray this merger as a takeover or acquisition to UK authorities – while continually playing up its egalitarian nature to the Canadian market. As a result, the additional compliance costs generated by the merger were likely to have been lower for UK officials than their Canadian counterparts, for the simple reason that the management of the firm would have been in the UK.

At the same time, previous policy moves that shaped the structure of the UK equity market and the allocation of regulatory authority over that market are important. They suggest that, even in a merger scenario where the LSE represented the junior partner (with an American incumbent or Deutsche boerse, perhaps), UK officials would not end up being as dependent on the LSE for agenda-execution in the British capital markets as Canadian officials are vis-a-vis

TMX. As a result, the merger was simply not as salient from a regulation and oversight perspective for the UK as it was for Canadian officials.

While the LSE Main Market is the pre-eminent exchange for UK listings as well as one of the world's largest in terms of volume and capitalization of firms, it is not clear that UK officials depend on the exchange to meet their public policy goals: for instance, in the provision of public goods such as pricing and market integrity, or the conversion of savings into capital. Indeed, the government commissioned a report into the UK equity markets in 2012 that found severe deficiencies in the degree to which equities markets were realizing those purposes - hardly an optimal state of affairs from a policy standpoint, but also a signal that the UK equities market may be generally detached from broader public policy goals (Kay, 2012). The fragmentation of the UK market, with trading taking place across multiple venues, is one culprit. Market share statistics lend support to this argument - by February 2011, when the deal was announced, the LSE had lost more than 35% of the volume in its leading index (FTSE 100) stocks to a single competitor, BATS-ChiX Europe, and held just over half the remaining volume, according to BATS public data (Korber et al., 2014). These numbers are a clear legacy of the EU's MiFID legislation, implemented in 2007, that broke the monopoly of the incumbent exchanges by enabling alternative electronic trading venues to enter the secondary market in listed stocks (Committee of European Securities Regulators, 2009; London Economics, 2010). The introduction of equity market competition has had a greater impact in the UK and EU than in Canada in ways that clearly lessen the public good-provision role of the exchange in terms of pricing efficiency or trade execution.

The allocation of statutory authority also plays a part in shaping the lack of public dependence on the LSE. The crucial decision point here is the establishment, in 2000, of the UK

Listing Authority under the Financial Services and Markets Act, which also established the (now-defunct) FSA. The UKLA in effect nationalized authority over the listing, disclosure, and prospectus rules for equities markets, rules that had previously been the domain of the exchange. In a sense, the creation of the FSA and UKLA was the culmination of a long process of regulatory nationalization that began with Thatcher's Big Bang, ending the centuries-old tradition of 'gentlemen's rules' in the City of London (cf. Moran, 1991).

Finally, a critical piece of evidence supports the logic of the argument presented here, and also establishes a key policy legacy that gave UK officials the tools they need to meet their goals regardless of the ownership and management structure of the LSE. In 2006 NASDAQ made a hostile takeover bid for the LSE – one that was soundly defeated by shareholders. This was one of several cross-border tie-ups involving the LSE around 2004-2007, including proposals involving Euronext and Deutsche boerse. The NASDAQ bid provoked concern within the UK regulator – then the Financial Services Authority – about the impact of rigorous US corporate governance rules under Sarbannes Oxley on LSE-listed firms and the London market – a concern very similar to that expressed in Europe during the NYSE-Euronext merger, at about the same time, and as is discussed in the next chapter.

Based on that regulatory concern, Ed Balls – then the Economic Secretary to the Treasury – drafted legislation to ensure that the FSA held a full veto over decisions made by the LSE's ownership and management (cf. Lee, 2010, p. 189). This would prevent any unwanted spillover of US rules, and a subsequent loss of control and influence for UK policymakers. Furthermore, this prophylactic measure led to a further centralization of power in the FSA, beyond the UKLA and away from the LSE – further weakening the public dependence on the exchange firm to make and implement rules. As Balls said in a public speech at the time,

It has been put to me that the right approach is government intervention to protect the LSE from foreign ownership. I reject this argument. This would fly in the face of traditions that have underpinned the City's success...A policy of protecting 'national champions' would damage, not bolster, the interests of London and the UK. The government's interest in this area is specific and clear: to safeguard the light touch and proportionate regulatory regime that has made London a magnet for international business. (Treanor, 2006)

This political viewpoint coincided with the concerns of the FSA and allowed for a solution to be put in place that would ensure, going forward, mergers involving the LSE would provoke fewer regulatory concerns. As a result, the response shows a clear strategic view on the part of Balls but also the regulators informing his decision to enact these legislative fix. More precisely, the challenges presented by this earlier merger were deemed to threaten the City's success as a light touch, open-for-business jurisdiction, and steps were taken to mitigate that. In short, dependence was fixed so that integration in the future could proceed.

Clearly, the overall conditions in the UK differed from Canada – even if the LSE had been a junior partner in the proposed merger with TMX, officials' dependence on the LSE for key policy goals had been attenuated by previous decisions regarding regulatory power and market structure.

### **Shadow case: SGX-ASX**

In October 2010 Singapore-based SGX announced an \$8 billion USD bid for ASX Ltd., the operator of the primary Australian stock and derivatives exchanges. In April of 2011 the Australian Federal Treasurer Wayne Swan blocked the deal on the recommendation of the Australian Foreign Investment Review Board (FIRB), as authorized by the Foreign Acquisitions

and Takeovers Act. It was the first decision blocked under that process since 2001 (Reuters, 2011). In reading the logic of the decision it is clear that the concerns of regulatory authorities, especially but not exclusively those responsible for the oversight and prudential supervision of ASX's clearing infrastructure, were primary causal factors.

Notably, the allocation of regulatory authority was less of a factor in this case than in Canada, as the Australian government had transferred most self-regulatory authority to the national regulator in 2009-2010 (Lee, 2010, p. 102). But overall the reason for this response was regulator dependence for the achievement of certain key policy goals, and this dependence was similarly based on an ASX-dominated market structure that was the result of previous domestic policy outcomes.

First, the ASX did not face notable domestic competition, and in 2010-2011 it controlled nearly 97% of Australian market turnover in equities: the alternative exchange Chi-X only entered the market in October 2011 (Australian Financial Markets Association, 2014, p. 60). Second, the consolidation of Australian market infrastructure – from six regional stock exchanges to just one, with the subsequent vertical integration of the Sydney-based stock and futures exchanges and post-trading facilities – mirrored Canada's and was similarly supported by politicians and officials: the Australian Parliament passed legislation to establish a consolidated national exchange in 1987. Moreover, the ASX clearing house was Australia's only significant post-trading clearinghouse facility, and it was (like in Canada) integrated into the exchange firm. This meant that multiple Australian regulators – market and prudential authorities alike – were stakeholders in the merger's outcome.

It is therefore to be expected that the logic of dependence from a market and prudential regulatory perspective is present the Treasury's reasoning (Australian Treasury, 2011; cf. Low

and Wong, 2011). First, Swan made clear that key regulators – the Reserve Bank of Australia and the Australian Securities and Investments Commission, the central bank and market regulator, respectively – opposed the merger (Smith, 2011). Second, the statement emphasized the “central role” of ASX as “Australia's primary equities and derivatives exchange and sole clearing house for equities, derivatives and bonds”, and in doing so clearly tied the uniqueness of the institution to officials’ concerns about control. The FIRB and Treasurer argued explicitly that the merger would result in consequences for Australian regulators’ control over the ASX, particularly its critical post-trading functions. The release stated that “not having full regulatory sovereignty over the ASX-SGX holding company would present material risks and supervisory issues impacting on the effective regulation of the ASX's operations, particularly its clearing and settlement functions.” This “loss of sovereignty” over an asset – measured by the Treasury as lost control over “material risks” and a resultant eroding of “effective” market regulation – was of particular significance to market officials in their efforts to realize specific regulatory outcomes. Indeed, the release stated that lost control would hamper concurrent efforts to “build Australia's standing as a global financial services centre in Asia”. But even more significantly, and again echoing the Canadian case neatly, the Treasury’s reasoning singled-out the impact on Australian regulators’ oversight over clearing and settlement functions. This demonstrates Australian officials’ calculation that they required unmitigated access and control over ASX to pursue a particular set of G20-directed policy goals related to the provision and regulation of post-trading services.

On balance, Australian officials weighed these costs and concluded that “the opportunities that were offered under the proposal were clearly not sufficient to justify this loss of sovereignty.” As in Canada, market officials deemed the increased costs of oversight and

control too steep and a threat to the realization of their policy goals, and stated so bluntly and publicly.

Subsequent policy developments further point to the causal impact of regulator dependence. On the heels of the SGX proposal the Australian Council of Financial Regulators, including the Treasury, markets regulator (ASIC), and central bank (RBA) embarked on consultations and recommended legislation to ensure that, going forward, they would have an appropriate level of oversight and influence over cross-border market infrastructure – including a territorial “imposition of graduated location requirements” for certain transactions and resources (Australian Council of Financial Regulators, 2012, p. 1). These tools are designed to increase Australian regulators’ statutory power vis-à-vis ASX and thus reduce need to lock-in a domestic management structure for the firm. In this way, the regulatory response is causally similar to the Ed Balls legislation in the UK, which also served to enable future cross-border integration by augmenting officials’ power over the firm in targeted ways, and thereby weakening authorities’ preference – or need – for domestic ownership and management. As in the UK, a merger proposal here instigated a conscious effort by officials to reduce their regulator dependence on a forward-looking basis.

What can we learn from the Australian government’s move? First, analysis of Swan’s decision and the FIRB advice behind it frequently questioned the political impartiality of the FIRB process. Many journalistic reports argued that the Labour government wanted desperately to avoid a bitter and anticipated fight in the legislature over the future of ASX, particularly because its minority coalition depended on independent and Green legislators who seemed opposed the bid. The deal would have to pass Parliamentary review upon FIRB and Treasury approval. While it is difficult to prove that the government directed the FIRB’s analysis

(something that is adamantly denied by the government and FIRB), it is possible that the FIRB and Treasurer may have been listening both to their regulatory officials as well as political opponents in the legislature: unlike the noise that political office-holders made in the Canadian example, Swan publicly stated that his government was not involved in the case and would only take a view on the basis of Australia's regulators' assessment. As his spokesperson put it, "[the merger] is a commercial matter for those involved and the relevant regulators" (Thurlow and Venkat, 2010).

However, the case bears the markets of regulatory dependence. As in the Canadian case, it is important to bear in mind that the governance of post-trading infrastructure has been at the forefront of contemporary regulatory dialogues about reducing systemic risk and moving OTC derivatives onto exchanges. This means two things. First, governments with strong regulatory links with post-trading infrastructure will have privileged roles in shaping the global regime that emerges from current debates, something that would have been understood in Australia as it was by the Bank of Canada as they initiated dialogues through the FSB on the 'Four Safeguards' for joint global CCP oversight on a college model. And second, the attractiveness of capital markets to investors will be continue to be shaped not only by liquidity and arbitrage opportunities but also by the availability of secure and well-regulated post-trading facilities. Australian efforts to retain control over the ASX's clearing and settlement infrastructure thus reflects its regulators' desire to retain autonomy over the Australian capital markets moving forward – and to do so in a manner that Australian policymakers choose.

Singapore is a unique case, and its particular dynamics are worthy of mention. SGX held a dominant market position at the time of the merger as the most significant Singapore-based exchange infrastructure firm, and it is an integrated infrastructure firm, with both trading and

clearing facilities incorporated into the group. However, these features of the Singapore market did not activate concerns about regulatory dependency. The reason is straightforward: SGX is not a typical for-profit and publicly-traded infrastructure firm, in that the government held an outsized 23.5% ownership stake at the time of the merger (the second largest shareholder came in at 4.9%) (Brown, 2010). In this sense, Singapore is a complete outlier compared to all the other jurisdictions studied in this dissertation, as the institutional set-up there is more akin to a development state corporatist model than a mature capitalist economy. However, if this choice of set-up for control of SGX is considered through the prism of the theory, it can be broadly argued that the response from Singapore's authorities is predicted: officials need not worry about the exchange drifting from their control and not undertaking their policy preferences because of the large public ownership stake in the firm. In this sense, the robust participation of officials in the management of the firm is a source of power, and to that extent an integration effort is not threatening. Dependence is low because control is so strong, despite the market structure dominance of SGX that might predict otherwise. Indeed, rather than provoke concerns in Singapore about lost control, the merger led to concerns in Australia about the politicization of the ASX – in particular, the merged group falling under the influence of the Singapore government and its authorities. Clearly the unique level of direct public influence over SGX meant that its internationalization was not seen by officials in Singapore as a threat to their policy execution – speaking clearly to the importance of direct control at the level of ownership and management. In this case, a market structure decision predicated on reinforcing the state's role in the management and oversight of the firm from an ownership position, as well as a market authority position, provided all the insurance SGX's regulatory supervisors needed.

## Conclusion

The evidence presented here strongly corroborates the expected observations of the theory. By focusing on a discrete case in which the levels of dependency are static and also variable from one jurisdiction to another – due to historical policy decisions – the chapter shows that the observed preferences and activities on the part of Canadian, British, and Australian authorities are indeed as the theory expects. Furthermore, the process leading to the two failed mergers followed the logic of the theory closely. Both the anticipated sources and levels of dependence are observable, and key stakeholders in Canada made clear that their decision making closely followed the theory's predictions, particularly with regards to the multiple and overlapping costs that were perceived to be imminent and unavoidable if the merger went through.

Moreover, these positive corroborations of the theory's empirical predictions are significant because other potential explanations for the observed outcome do not – for the most part – stand up to scrutiny:

- Neither political office holders nor organised, unified business interests successfully exercised influence over the Canadian officials who moved against the mergers, as demonstrated in the first discussion in this chapter; Australian officials similarly faced ambivalent pressures from both the political and private sectors (Smith and Azhar, 2011).
- Of the jurisdictions analyzed in these cases, three of the four could reasonably be classified as “liberal market economies” under a VOC typology (Canada, the UK, and Australia), and yet two of these feature regulators that come down against mergers while a third (the UK) does not, making it difficult to propose an efficient regime-type explanation;

- The Canadian case could be explained by systemic concerns of a mercantilist nature, as could the Australian case. In both jurisdictions, the opportunity costs of not building commercial links with a large (and in the Canadian case, significantly larger) foreign market appear to be outweighed by the countervailing concern that integration will result in a zero-sum, race-to-the bottom dynamic in which the smaller market will lose. As a result, a potential Stolper-Samuelson explanation for merger outcomes remains worthy of consideration after this chapter – i.e., a mechanism by which the relatively “capital scarce” jurisdiction in a given dyad protects the value of this scarce factor. This potential mechanism, however, does not withstand scrutiny in the subsequent chapter.

In contrast to these explanations, the theory of regulator dependence fares well in this chapter. Table 5 captures the degree to which the expected observations are indeed available in each of the two jurisdictions that where regulators stepped in to block the merger, and as demonstrated in the previous discussion and summarized here, each of the two scope conditions (O1 and O2) and subsequent falsifiable hypotheses match the expectations generated by the theory. Moreover, in the UK previous policy moves to shore up direct control in response to a historical merger proposal led to lesser degrees of dependence and the predicted neutral-to-positive response on the part of the authorities there, where the merger did not present the same issues and the anticipated costs for the then-FSA were considered lower. Finally, in Singapore, the direct nature of government control at the level of ownership is, as discussed, correlated with a degree of support for the merger that is unique in all the cases studied in this dissertation, but consistent with the general expectation that lesser degrees of dependence will neutralize opposition to mergers on the part of regulatory authorities.

Table 5

*Summary of Chapter 5 empirical observations*

<b>Jurisdiction</b>	<b>O1: Regulators' insulation</b>	<b>O2: Regulators' concerns about costs</b>	<b>O3: Regulators' response</b>	<b>O4: Regulators' dependence</b>
Canada	High – Canadian financial institutions not aligned; Canadian politicians not aligned	High – potential costs to oversight, control, and agenda execution all noted by regulators	Negative – merger leads to regulatory concerns at provincial level, interfered with by federal regulators	High – due to centralization and vertical integration of exchange functions in TMX, decentralization of regulatory authority in Canada, and residual self-regulatory powers at the firm level
United Kingdom	Not strictly observed	Observed in previous merger proposal, leading to effort to minimize dependence	Positive	Low dependence on the firm – significant previous re-nationalization of exchange powers in response to previous mergers
Australia	High – Key Australian financial institutions lobbying for merger; Australian politicians not aligned	High – ability to execute and oversee key agenda items and services singled out as sources of concern	Negative – merger blocked	High – due to centralization and vertical integration of exchange functions in ASX and diffusion of regulatory authority across public entities

<b>Jurisdiction</b>	<b>O1: Regulators' insulation</b>	<b>O2: Regulators' concerns about costs</b>	<b>O3: Regulators' response</b>	<b>O4: Regulators' dependence</b>
Singapore	Not strictly observed, but likely confounded by SGX-government ties	No observed concerns about costs – high degree of direct government control over SGX	Positive – merger supported	Low dependence on the firm – high degree of direct government control over SGX

Given the extent to which dependency ought to be present in Canada and absent in the UK, due to the policy choices made over the last two decades, this case in many respects presents an easy first test for the theory, which it has survived. However, the cases discussed here also contained interesting details not explicitly predicted by the theory, albeit broadly consistent with its expectations. First, in Australia and the UK, authorities can be seen taking steps to build new public sector capacities vis-à-vis the exchange firms as a direct result of merger proposals. In the UK the merger proposal in question (with the NASDAQ) is beyond the scope of the analysis, but the legislative fix driven by the Financial Services Authority to establish the UKLA, and ensure that regulatory authority over the LSE has since that failed merger sat with the British regulator and not with the firm, is an example of this shoring up of public capacity. The Australian prudential authorities' initiation of new requirements, particularly for the ASX's clearing business, in the event of a future, successful cross-border merger involving that company are another. And finally, the Singapore government's strong position behind the exchange, i.e., its being in an ex ante position of control and influence, is a third such observation, albeit one of a different and state corporatist nature. None of these observations undercuts the theory (indeed, they are consistent with the cost and control based

mechanisms posited in this dissertation) so much as adds fascinating nuance to the manner in which officials are able to buttress their power resources, at a mechanical level, and further evidence about the choices they make to do so, at a political and policy level. The theoretical are discussed further in the conclusion to the dissertation.

The dissertation now proceeds to a more complex test of the theory, by examining three mergers involving Euronext in which the exogenous conditions of dependency vary from episode to episode – not least the broader policy agenda being pursued and the levels of integration already in place in the European capital markets.

## **CHAPTER VI**

### **THREE MERGERS INVOLVING EURONEXT: A DYNAMIC TEST OF THE THEORY OF REGULATOR DEPENDENCE**

#### **Introduction**

This chapter focuses on the transatlantic merger of Euronext with the New York Stock Exchange in 2006-2007. The purpose in this chapter is, first and foremost, to show that the approval of NYSE-Euronext can be efficiently explained within the framework of the theory of regulator dependence. However, it is notable that this cross-border merger is not the only one that Euronext has been involved in. Indeed, Euronext was itself the product of an intra-European merger in 2000-2001 previous to the transatlantic tie-up; and Euronext was subsequently divested from the transatlantic NYSE-Euronext firm as a byproduct of another recent round of consolidation, in 2013. This chapter considers the NYSE-Euronext merger, which is the focus of the chapter, as well as these two additional merger proposals involving Euronext. All three were approved, and that regulatory success story is considered in this chapter. (A fourth merger involving NYSE-Euronext that was blocked at the European level is explained in the next chapter, where it presents a much different test of the theory.)

As the chapter shows, each proposal was subject to different political concerns and each merger was treated differently by market authorities as a result – that is, each was approved on the basis that certain political and regulatory conditions were met, and those conditions were different for each merger. In briefly discussing the previous and subsequent mergers that Euronext was involved in, the chapter therefore demonstrates that varying degrees of dependence across time result in varying regulatory reactions to cross-border merger processes, in ways that

are also consistent with the theory. Whereas the previous chapter examined static conditions of dependence in place at the time a single merger was proposed, the Euronext case is instructive because it demonstrates the impact that changing levels of regulatory dependency goals has on the processes that accompany cross-border tie-ups involving those exchanges.

The chapter thus proceeds in three sections. In the first, the initial merger in 2000 that created the Euronext exchange from the Paris, Amsterdam, and Brussels bourses – later joined by Lisbon and the London-based LIFFE derivatives exchange – is briefly considered, and is explained by reference to the broader European capital markets integration that was proceeding alongside. This section does not test the theory in a detailed manner, but it does provide important background and highlight the broad synergies between what European regulators were pursuing from a policy perspective, and the role the merging exchanges played by complementing that regulatory agenda.

The second section considers the merger between the New York Stock Exchange and Euronext to create the transatlantic NYSE-Euronext conglomerate in detail; this was a proposal that was subject to considerable cross-border regulatory politics and it is necessary to rigorously test the theory against this important case of an approved transatlantic merger. In this section a near-simultaneous merger between NASDAQ and the Swedish based Nordic conglomerate OMX is also very briefly discussed.

The final discussion considers the recent takeover of NYSE-Euronext by another American firm, the Intercontinental Exchange (ICE) based in Atlanta, a merger that was approved in 2013. Critically, European authorities' approval was subject to the condition that Euronext be divested and returned to predominantly European ownership and exclusively European management.

The main argument presented in this chapter is that, as in the cases examined in the previous chapter, the level of regulator dependence is a strong predictor of the manner in which public authorities will react to a proposed cross-border merger. Importantly, the chapter shows that, where levels of regulator dependence are low, it remains the case that the authorities responsible for market outcomes are concerned about retaining their capacity to direct and oversee the exchange firm as they see fit. As demonstrated in this chapter – and in a manner consistent with the Ed Balls-sponsored legislation in the TMX-LSE case, discussed above – authorities take steps short of blocking the merger to shore up their oversight and power. This demonstrates the degree to which the costs of a cross-border merger proposal to authorities (a key causal mechanism in the theory) are always salient to regulators, but confirms that regulators only block mergers in conditions where their dependency on the merging firms requires it.

Interestingly, the cases examined here suggest that where levels of regulator dependence are low, cross-border mergers may in fact be seen authorities to complement some broader regulatory agenda, rather than simply present inexorable risks to their policy work. This can be observed in the first two Euronext cases discussed in this chapter, and it is noted in the discussion of those cases. This suggests that where overall dependence is low, market authorities may consider the opportunities that merger proposals present – for instance, to encourage or complement regulatory harmonization efforts.

Finally, the chapter demonstrates the impact of changing conditions of dependence on merger proposals. Indeed, after NYSE-Euronext had been approved, a subsequent tie-up between an American exchange firm and Euronext led to the divestiture of Euronext and its return to European ownership. This is because European policymakers determined that, in a post-crisis financial environment, European capital markets would become a more prominent

source of funding for small and medium size enterprises, and banks retrenched. The chapter concludes with a brief discussion of this interesting outcome and relates it back to the theory of regulator dependence.

### **The initial Euronext merger**

The merger between the Paris, Amsterdam, and Brussels bourses in 2000 took place against the background of a flurry of intra-European merger proposals. Many of these – including consolidation involving the LSE and its Frankfurt-based rival Deutsche Boerse, pan-Nordic proposals, and Swedish attempts to lure LSE into a merger – failed on the varying commercial and, in some cases, regulatory impediments that they faced. These proposals are each fascinating but beyond the scope of this brief discussion. What is important to flag is that Euronext succeeded because its stakeholders were able to overcome background inter-jurisdictional tensions, including nationalism and the different regulatory legacies of the various European Member States, and put together a proposal that worked from an industrial and commercial perspective. It was not an inevitable deal: in a commercial context marked by uncertainty and, to read the reports at the time, a certain frenzy regarding ‘who would merge first, and when’, any number of proposals could have taken place. But what is critical to flag is that given the broader economic and policy context at the time, consolidation was very much on the agenda and it resonated with those who were simultaneously building a pan-European capital market for the first time: namely, market authorities and leading market participants. This quote from Martin Wheatley from 2000, embedded in a deeper piece of regulatory analysis by a leading expert, is instructive (Wheatley was then director of business development for the

London Stock Exchange, and notably later became the head of the UK's Financial Conduct Authority, the leading British market conduct regulator):

To build a truly pan-European trading platform, consolidation is inevitable. It's what broker-dealers and investors desire, and it's what the exchanges themselves now appear to want. The question that remains is who gets what. "What the market is crying out for is consolidation of existing stock exchanges," says Martin Wheatley, director of business development for the London Stock Exchange. "Our customers want us to rationalize the business we are in." The drive toward consolidation coincided with the arrival of the euro in January 1999. For centuries the bourses reflected the nationalist urges of European countries. The euro turned that upside down. Investors have increasingly abandoned investing by reference to country weights in international indexes, preferring a pan-European sectoral approach. (Capon, 2000)

Capon argues further that, while at the time of the Euronext merger domestic trading in Europe was quite cheap, cross-border trading was prohibitively expensive, especially due to onerous transaction costs resulting from different regulations and dual-registration requirements. There was a general view that to get prices down, and fundamentally stoke the development of pan-European capital market development (a goal not fully realized to this day), the exchanges themselves would have to merge. In a very important sense, then, Euronext was the first mover in an environment of substantial expectations and demand – from both the market and from regulators – for consolidation within Europe (Boland, 2000a, 2000b). In fact, Capon suggests that collusion in the industry kept many mergers at bay as the incumbents sorted out their respective domestic markets and sought more traditional cross-border alliances and synergies:

the Euronext exchanges broke that “unholy alliance” and set off the European fascination with exchange consolidation over the next decade (Capon, 2000).

To a large extent, then, Euronext was approved and even cheered from a regulatory and policy perspective because it coincided with European Monetary Union and the aspirations of the various capital market integration proposals gaining traction in Europe at the time (Clausen and Sorensen, 2009). The former CEO of the Amsterdam exchange explained the merger as a product of its time and place, colloquially: “In that period, the late 1990s, Europe and especially the Netherlands were looking to set up a single capital market. You had new institutions, like the ECB, and the Euro coming in. So you have to imagine yourself in that timeframe” (Anonymous Interview, Amsterdam, February 20, 2014). Indeed, the next few years saw ambitious European market-building policy efforts in the form of the so-called “Lamfalussy Report” European Directives that sought – without enormous success – to harmonize the various prospectus, listing, transparency, and other investor protection rules in place across European markets (Quaglia, 2010).

Most importantly, the merger of Euronext made sense from the perspective of pro-integration regulators embedded within the newly-created Eurozone, and it indeed complemented their specific capacities at the time. In European markets where banks ruled, the goal at the time of the Euro’s introduction was to provide a corollary in the form of deep, market-based funding mechanisms for European firms, particularly SMEs (Posner, 2009a). Regulators faced significant impediments – some of them political, others technical – to their efforts to build the harmonized ruleset that would underpin such a single capital market (McAndrews and Stefanadis, 2002). In this sense, Euronext could prove to be a market-side partner for regulatory harmonization on listing, trading, and disclosure rules, enabling further

and faster harmonization than was politically possible at the time. To some extent that role was immediately realized (Boland, 2000a, 2000b). For instance, Shipp argues convincingly that the College of Euronext Regulators, a confederal oversight system created to oversee the merged bourses, has worked to “fill gaps in European Union Securities Law”, and that Euronext “and other cross-border European securities exchanges have pushed regulator to converge national securities law”, notably by harmonizing the Rulebook (Shipp, 2007). In short, Euronext could commit to undertakings at a market level that regulators in the merging markets wanted to do already – namely, harmonize and then promote European capital markets. The spotty history of European markets harmonization would likely be even spottier without a merged Euronext firm doing some of the work of standardizing listing and trading rules across several of the significant European markets.

This brief discussion has elaborated the genesis of a European exchange conglomerate without fully testing it against the theory. This is, first, to attempt to address any endogeneity in the subsequent analysis of the NYSE-Euronext merger, i.e., to show that a pro-merger mindset within Europe at the time of the merger should not necessarily be read as a pro-merger mindset on the part of continental European regulators in general. There were particular, time-bound reasons for European regulators to support Euronext in 2000; those same reasons do not necessarily obtain in 2006-2007 during the transatlantic merger process.

Second, this discussion has briefly highlighted the fact that pro-integration markets officials that were constrained by the political and legal institutions available to them as they sought to harmonize European rules may, in fact, have benefitted from the merger. To the extent that such authorities were dependent on their bourses at the time, it is probable that a large part of that dependency was rooted in the capacity the exchanges had to formulate a rulebook – upon

that rulebook's delegation by the College of Euronext Regulations. In this sense, the merger complemented – rather than threatened – the policy goals they sought at the time. The Euronext merger was in fact born of dependence on those firms to accomplish political goals, rather than a contradiction.

### **The first transatlantic tie-up: NYSE-Euronext**

In early 2007 the US Securities and Exchange Commission and their European colleagues (working independently and also through the College of Euronext Regulators) approved the \$14 billion USD merger of the New York Stock Exchange with Euronext, a Paris-based exchange operator established by the previous mergers of the Brussels, Amsterdam, and Paris bourses, plus (later) the Lisbon exchange and the London derivatives exchange LIFFE.

Why was this merger approved?

### **US and EU regulators' insulation**

First, it is necessary to demonstrate that the alternative explanation of social pressures – either through business influence or electorally-motivated political office-holders – was not causally significant.

The two most significant European jurisdictions in terms of registering approval were France (as the largest market and exchange component in the merged firm, and its corporate centre) and the Netherlands (as NYSE-Euronext was owned by a Dutch holding company – for tax purposes – giving the Dutch authorities an important veto). It is important to establish that the approval of these two jurisdictions was not motivated by either business or political interests. Taking these in order, Callaghan and Lagneau-Ymonet (2012) have analysed the French

approval of the merger in detail, as was discussed above. Their findings are consistent with the claim advanced here that public authorities were in fact able to pursue an independent decision, which in France was the result of a fragmented and disunited interest group approach to the merging proceedings. The French case thus mirrors the Canadian case in the manner in which it split the business community, and the impact that it had on the relative insulation of key French decision makers. The authors argue convincingly that the merger went through over the opposition of significant – but not all – portions of the French business and corporate elite because neither convincing patriotic arguments nor feasible domestic alternatives were available to the French interest groups that lined up against the merger. In one fascinating example, French bank BNP Paribas opposed the merger even though it was advising Euronext on the merger and stood to profit from it (Arnold and Cohen, 2006). That is, the French market regulator (the AMF) and key political institutions (including the French Trésor and others) did not move against the merger despite the protestations of significant portions of the business community, because those groups did not present a feasible alternative and were intellectually and political inconsistent among themselves, in terms of their preferences for the Paris Bourse. In one sense, then the French case was the converse of the counter-offer dynamic observed in Canada; but it presented the same disunited lobbying efforts resulting in freedom to act for public officials. This left French market officials free from business interference and able to approve the merger.

Even more notable, perhaps, is that the French regulator approved the American merger bid against the publicly-declared preferences of the French government: Jacques Chirac became involved in the deal and expressed a desire to see Euronext merge with its German rival Deutsche boerse (Arnold et al., 2006). That he was not successful is clear evidence that the

political goals held by the highest elected official in France did not inform the merger's eventual outcome, further supporting the claim that French officials were not influenced by either business or political-electoral forces in their decision-making. Given the broader approach in France to mergers and acquisitions in large strategic sectors involving foreign firms, this is indeed a noteworthy set of observations (Callaghan ,2014).

In the Netherlands and in Belgium as well, the business community was concerned to ensure that participants in the local markets – particularly publicly-listed firms – would not be materially affected by the merger. In fact, listed companies were deeply concerned about the merger, but rather than impede it, they allowed policymakers to devise solutions. As one Dutch official close to the merger explained, when asked if there had been lobbying from the business community during this merger: “Not particularly – at least not towards the ministry or the minister. The Central Bank and [Dutch markets regulator] AFM represented some of the interests of the large banks, and took an interest in how it would develop. But there was no lobbying, really, or of the Minister anyways” (Anonymous Interview, The Hague, February 21, 2014).

This same official went on to explain that from the Dutch perspective, the key was protecting the interests of the Dutch companies that rely on the markets – officials independently sought guarantees that the Dutch listings environment would remain beneficial to those companies, because such an outcome was part of their mandate, and would be expected of them as part of their due diligence around the proposal. As the official explained it, “we developed a strategy targeted at maximizing influence on the merger process, and getting the best for the Amsterdam trading system. Particularly, this was done on behalf of the quality of the market for Dutch companies, and their possibilities in a broader capital market” (Anonymous Interview,

The Hague, February 21, 2014). The Dutch corporate community's approach to the mergers was not to weigh in favour or against, but to seek assurances that regulators approached the mergers in a manner that protected the existing approach to market regulation. As a former Amsterdam exchange official explained:

The big multinationals in Europe, they were afraid of intervention of the SEC. Shell, Unilevel, Philips – so their condition to allow the mergers was about this. So this was what led Dutch decisionmaking on Euronext NV. So we came up with solutions... [and] used a Stichting – this was to keep the regulatory environments separate. This would address any conflicts within the group – such as, the SEC intervening, trying to get information from European banks and companies. The French, Dutch Euronext multinationals were putting pressure on this. (Anonymous Interview, Amsterdam, February 21, 2014)

In this important sense, any lobbying that took place in Amsterdam was aimed at the limited goal of ensuring Dutch policymakers continued to enjoy freedom from American policy interference. In this sense the interests of the business community overlapped with the interests of Dutch regulators in looking at the merger from the perspective of their policy autonomy. Notably, to the extent that the business community expressed concerns about the merger, it is important to recall that it was ultimately approved: it is difficult to assert that this approval was the result of any soft lobbying against certain aspects of transatlantic market integration.

Indeed, the Dutch authorities' approach was to ensure that the health and viability of the broader Amsterdam market would continue to be served no matter the outcome – and the manner in which they were able to lock in guarantees for the Dutch market, through an arrangement called a “Stichting”, is explained below. Similar concerns about how listed firms would be

affected by the merger influenced Belgian decision making on the merger (Anonymous Interview, Brussels, June 18, 2013).

The American process was similarly devoid of significant lobbying or significant electoral incentives in the manner in which these mergers were settled, and on the SEC's decision to grant approval to the tie-up in 2007. An anonymous SEC official replied bluntly when asked if businesses inside or beyond the exchange community had lobbied either Congress or the Agency on the deals: "Nope, [there was] none. Traditional exchanges don't matter" (Anonymous Interview, Washington DC, November 15, 2012). On the further issue of Congressional involvement, he noted that the SEC was left alone to pursue its work and due diligence on the merger, and that as the SEC become comfortable with the merger and expressed that comfort, Congress did not interfere at all: "the SEC was publicly clear in asserting that it had zero regulatory objection to the mergers. Nobody called them up to the Hill to explain that" (Anonymous Interview, Washington DC, November 15, 2012). A second former SEC official made a similar argument, noting that there wasn't a clear Congressional role because the mergers were "hypertechnical", and noting that politicians "get themselves in a lot of trouble when they get involved in things and don't know what the hell they're talking about" (Anonymous Interview, Washington DC, November 14, 2012). While this lack of business mobilization is initially surprising, the claim that "traditional exchanges don't matter" is, in fact, at the core of the issue: the major users of the exchanges did not see anything controversial about the move because American market structure had more or less moved on from the incumbents, including NYSE. This is developed below.

The Congressional record corroborates this claim, although with some caveats. The Senate banking committee's Subcommittee on Securities, Insurance, and Investment held a

hearing on cross-border exchange mergers in July of 2007, and the SEC was indeed asked to present (United States Congress, 2009). At that meeting, an SEC official presented an academic (i.e., non-Agency) perspective on “mutual recognition” with an academic colleague. The paper did not weigh in directly on the merger, and instead outlined then-current debates pertaining to how exchanges could gain direct access to each other’s markets on the basis of equivalent regulatory standards. Mutual recognition is tool that, as discussed below, the SEC has never adopted, with implications for the merger. The SEC’s discrete and official position on the merger, which was presented separately, was neutral in the manner described by officials in interviews, and it was not subject to the committee’s interrogation. Moreover, the business community did not directly lobby one way or the other on the mergers at this sub-committee meeting. NASDAQ, involved in its own tie-up with the Scandinavian OMX group at the time (see below), was asked to present, and a senior executive explained that it was important to ensure the SEC did not export its regulatory preferences on an extraterritorial basis, and that American capital markets regulation should be fair and measured when compared to that of its global peers. These issues were indeed important considerations in both the broader discourse and in the merger decisions themselves, as is treated next. But neither issue reflected a significant and considered attempt to lobby either the Agency or its political bosses on the specific outcome of this merger – indeed, these were background policy issues that influenced the debate about the merger (and in the case of business interests seeking a lighter-touch from the SEC, the merger presented an opportunity to rehash existing arguments about ‘declining’ US competitiveness). However, as is demonstrated more forcefully next, even these cross-border regulatory harmonization issues did not have an impact on the eventual outcome. There is, in short, very little evidence in the US case of the kind of political and business opposition that can

observed either in France (where businesses and the president were largely ignored by the authorities) or in Canada (where there was considerable noise emanating from both sides of the debate). In the US, the merger did not appear resonate.

### **The threat of regulatory spillover and arbitrage: a cost-based problem**

It remains puzzling that, given their space to independently review and act on the merger, the US and European authorities come down in favour of the proposal. As the theory expects, there is ample evidence that regulators, particularly but not exclusively European regulators, were worried about the costs to their capacity and autonomy that the merger would pose. In response, they undertook a series of steps to shore up their capacity and lock-in the exclusively domestic oversight that they felt they needed to gain comfort with the merged entities' undertakings on a cross-border basis. This particular cost-based mechanism was clearly front in centre in the minds of regulators on both sides of the Atlantic – although one former European exchange official noted that the focus was on the wrong set of costs, and that the autonomy to direct the exchange towards locally beneficial commercial activities was the true cost of the NYSE-Euronext merger (Anonymous Interview, Brussels, June 18, 2013).

The merger presented European authorities with worries that the SEC would attempt to export its regulations into European capital markets in a way that would have a deleterious impact on the unique corporate governance and listing requirements they had tailored for European firms, i.e., in an extraterritorial manner. This concern dominated the regulatory discussion regarding the merger for several months after it was proposed (Grant, 2006a, 2006b, 2006c). From the European regulators' perspective, the SEC's involvement could well have resulted in the introduction of bargaining with the SEC over the appropriate domestic (European)

regulation of domestic (European) markets, which could have led non-desired outcomes in terms of the particular listing and capital raising undertakings available to European firms, and the regulatory obligations of all market participants. More precisely, for the Euronext regulators, the source of concern was that in a post-merger environment in which the merged firm could potentially reduce cross-border transaction costs and encourage arbitrage on the part of its clients, the US SEC would have incentives to apply pressure to narrow the regulatory gap, and even close the gap itself by seeking to regulate European capital market activity. The converse argument was also presented: business groups argued for the need to ensure that American capital market regulation was fair and proportionate precisely because of the potential for arbitrage away from US markets. This was the a subject in NASDAQ's testimony to the Senate committee discussed above; it was also a significant agenda item for a broader coalition of US interest groups that produced studies and lobbied assertively on this basis at the time, particularly through a group called the Committee for Capital Markets Regulation. European regulators appear to have feared that this American regulatory pressure, whether through direct SEC engagement or through other dialogues aimed at policy convergence, would find a way into their markets via the NYSE-Euronext merger: i.e., they had a Trojan horse concern. Such a result would hamper their regulatory monopoly as well as their ongoing efforts to build competitive European capital markets.

The reason for this particular concern has to do with the very real potential for transatlantic regulatory arbitrage that presented itself at this time. The particular synergies sought by the exchange firms involved in these mergers were too numerous to detail here, and must be bracketed out; however, certain knowledgeable observers suggested that, beyond the broad reason of wanting to get into growing and integrating European capital markets, one

specific reason for the American exchanges' move to Europe could have been the regulatory differences between those jurisdictions (Maiden, 2006; cf. Karmel, 2007; Coffee Jr., 2007). To some extent, this could be seen in the firm's subsequent marketing strategy: on its internet website for many years after the merger, NYSE-Euronext offered prospective clients two buttons presenting the choices to "List in the US" or "List in Europe" – a clear demonstration of a single firm offering prospective public firms the choice of regulatory environment. It is important to note, however, that this marketing strategy occluded very real regulatory barriers that maintained the autonomy of the US and European authorities. SEC officials were indeed cognizant of this possible incentive and sought to ensure that the merged firm would not be able to fully pursue it (Anonymous Interview, Washington DC, November 15, 2012).

Why was arbitrage a concern? The historical advantage enjoyed by American capital markets was perceived in some quarters to have been eroded by the post-Enron imposition of strict corporate governance requirements on public firms choosing to list in the United States (McKinsey, 2007). The Sarbanes-Oxley (SOX) legislation was at the core of these assessments, particularly Section 404 of SOX that generated executive liabilities for financial reports, as well as broader regulatory changes relating to the configuration of accounting and auditing processes within the firm. There were debates about the accuracy of this compliance-costs argument but it carried significant weight at the time and was viewed by many as a significant policy challenge (Karmel, 2004; Romano, 2009). The business-backed Committee on Capital Markets Regulation was very much focused on this particular source of 'non-competitiveness' in the US markets (Committee on Capital Markets Regulation, 2006).

The result was that European regulators were concerned that the merging of their exchanges with the more heavily regulated US exchanges would bring the SEC's power and its

particular regulatory preferences – especially vis-à-vis corporate governance of listed firms – with it. There was precedent for this concern. As the world’s capital markets have integrated and American firms and investors have become increasingly active in foreign markets, the SEC’s strong commitment to its investor protection mandate has frequently led it abroad to pursue converged standards and information-sharing arrangements with overseas authorities, with considerable success in some issue areas like insider trading (Bach and Newman, 2010b). Furthermore, the litigiousness evident in American securities law enforcement made and continues to make European companies seeking access to US investors nervous about their legal exposures, no matter where they are listed. These dynamics were observable outside of the specific context of the NYSE-Euronext merger, but were highly salient during the merger – in fact, they dominated the policy debate, to the possible detriment of other important issues such as management autonomy for the merged firm (Anonymous Interview, Brussels, June 18, 2013). As a result, the Europeans were worried that a merged exchange firm might bring the SEC’s actual statutory authority with it – that is, they were worried that the SEC would be able apply Sarbanes-Oxley in their jurisdictions, to the detriment of their ability to independently shape and promote the competitiveness of those jurisdictions. This concern came on top of a more general concern that European regulators have about the SEC’s extraterritorial interests and its ability to use US capital market dominance to draw foreign regulation towards its preferences (Karmel, 2004; Gadinis, 2008b; Bach and Newman, 2010b).

To buttress their regulatory capacity and protect against these potential costs to their autonomy, the European authorities made use of two policy tools: a memorandum of understanding, and an independent review and advisory board specifically designed to watch for cross-border conflict.

First, an MOU was signed between the SEC and the College of Euronext Regulators that clearly spelled out the terms of cooperation and exclusive jurisdictional capacities of the American and European regulatory bodies over the firms operating in their markets (Grant, 2006d). While not legally binding, the MOU made clear that under the status quo regulatory environment at the time of the merger, there would be no cross-border interference beyond the cooperation and information sharing that both sides needed to do their jobs effectively. This document served as a focal point around which subsequent regulatory cooperation (as well as any inter-jurisdictional conflict) could be resolved.

Second, Euronext was made to commit by its College of Regulators to certain undertakings with regards to the management board, the approval of subsequent transactions and mergers, and related corporate governance related items. Importantly, Euronext was also asked to agree not to undertake any business activities that would undermine the spirit or purpose of the MOU signed with the SEC (van Leeuwen, 2006).

Third, and more innovatively, a three-person board or 'Foundation' was established at the behest of the Euronext College, consisting of two Europeans and one American (Cohen and Authers, 2006). This foundation – called a 'Stichting' – had its roots in Dutch corporate law and was indeed proposed by the Dutch component of the Euronext regulatory community (Anonymous Interview, The Hague, February 21, 2014). Its purpose was to periodically review and report on regulatory changes in either jurisdiction that may have a negative impact on the competitiveness or business activity of the exchanges or major capital market participants on either side of the Atlantic - in short, the Stichting would monitor for regulatory spillover and report on it. In the event of spillover, both sets of regulatory authorities had recourse to impose certain undertakings on the Dutch holding company that owned NYSE-Euronext, and could even

force the holding company to divest itself of the European or American half, returning both exchanges to a single-territory management structure (i.e., American and European). This Foundation was deployed by the European authorities to ensure that they a “nuclear option” in the event of any unwanted regulatory side-effects, but also to gain assurances and leverage in their negotiations with the SEC on the regulation of the merged firm. As a Dutch official close to the merger put it, as a result of the Stichting approach, “primarily we got an MOU with the SEC and the European partners about who would do what,” in addition to other assurances relating to board composition and division of competencies (Anonymous Interview, The Hague, February 21, 2014).

The SEC had similar concerns regarding its oversight and control, particularly regarding the risk of arbitrage. Several former officials explained that the SEC had concerns about its ability to unilaterally impose regulations on a transatlantic firm costlessly, i.e., without encouraging arbitrage or experiencing shirking on the part of the American component (NYSE) of the merged firms. As one put it, “if this [deeper integration of the exchanges] were to happen, the SEC would be severely worried” (Anonymous Interview, Washington DC, November 14, 2012). The SEC’s primary concern was to ensure that the American enforcement regime would remain intact so that they could continue to deliver on their investor protection mandate. This meant in particular maintaining access at the level of NYSE’s directors and corporate management, in order to ensure that sufficient capital was allocated to desirable business activities and in order to enforce compliance in the event of a breach. And finally, the SEC was cognizant that US capital markets were perceived to be under pressure, particularly as a result of SOX - although the extent of that pressure was empirical debated, as was noted above (Gangahar, 2006). This led to concerns that merging firms, which would soon face lower exit

costs and could be able to facilitate exit and arbitrage on the part of their clients as well, would complicate the SEC's policy realization efforts regarding the new Sarbanes Oxley corporate governance regime.

The SEC approached its concerns with policy tools and initiatives of its own, in response to the merger. In particular, the Agency established new rules for the governing structure of the merged firm, particularly with regards to board members. The SEC wanted to ensure that a transnational board of directors was still chiefly beholden to US securities laws, and so their lawyers wrote careful language into the by-laws of the merged firm to ensure that that exact capacity was built in.

In doing so, the SEC retained what one former SEC official agreed was akin to a "golden share" in the merging firms, a policy that it had initially developed in response to a previous, unrealized merger proposal that did not proceed beyond an initial exploratory phase. The result was that the SEC had the power to approve and veto any subsequent changes to ownership and management. This way the SEC ensured that a merged firm a) remained effectively monitored by its officials and b) could not drift further away via a subsequent merger. As the former official explained it,

It's a failsafe: [if the new] owner starts to do something that harms US markets, they [the SEC] say forget it. So this is a key term: change in the ultimate owner is a bylaw and has to be filed with the SEC. The SEC's blunt tool here was its approval and recognition orders, which it could remove in the event of non-compliance with these by-laws.

(Anonymous Interview, telephone, February 22, 2013)

From the perspective of the SEC's legal team, these powers were sufficient to give the Agency comfort about the merger: on the US side, the power over the merged firm's by-laws was akin to

the Stichting solution from the European perspective. In both cases these moves gave regulators a “hook” into the merging firms at the holding-company level that was deemed sufficient; a similar device was not tried in Canada or Australia, despite similar concerns about control at the holding company level, which suggests strongly that it would not have sufficed given the different, dependent positions of regulators in those jurisdictions.

That the tools described above were palatable to European and US authorities worried about the merger is the first element that is in need of explanation. Indeed, the SEC’s chairman and many of its commissioners took pains to make clear that, so long as the merged exchange firms continued to operate separate European and American listing platforms, the SEC’s regulations and authority would only apply to those firms listed on the US side. The SEC made public commitments to this transatlantic division of regulatory competencies in June 2006, and one of its Commissioners, Annette Nazareth, explained in an interview with the Financial Times that “[she] cannot conceive of how that [spillover] is going to happen. US law does not apply unless you are listed in the US, or you choose to do business in the US” (Authers et al., 2006).

This signal achieved the support of European authorities, in concert with the various tools they deployed to lock in their existing powers. The College of Euronext Regulators sent the CEO of Euronext a letter on 5 December 2006 in which it elaborated its non-objection to the merger, subject to commitments from Euronext elaborated above. On the basis of the Stichting model, the Dutch Finance Minister – who wielded a veto alongside the Euronext regulators – also signalled his non-objection to the merger in an 18 December 2006 letter addressed to the merging firms, but Zalm also noted that the Dutch approval was subject to the terms and conditions of the Foundation and its ongoing capacity for review.

These tools are consistent with the theoretical expectation that authorities will seek to buttress their capacity to exercise oversight and control over merging exchange firms, and thereby ensure that their autonomous capacity to direct those firms towards desired ends remains intact. That is, these tools protect market authorities from the potential costs of trying to reign a merged exchange firm back into compliance at a later date. But a puzzle remains – why were such tools acceptable to the SEC and Euronext regulators when solutions of this type were not equally acceptable to Canadian and Australian authorities? This is especially puzzling since, given the sequencing of the mergers, the Canadian and Australian authorities could have learned from these existing US and European efforts and replicated them. There is clearly an additional factor that explains why, in some cases, policy innovations of the sort adopted in this merger are enough to gain a regulator’s approval for a cross-border merger. Why, in short, were these efforts considered to be sufficient to buttress the power of the authorities involved in the merger?

### **A dependency-based explanation for approval**

Clearly, both American and European authorities were willing to adopt a series of innovative policy approaches in the context of this merger to ensure that their specific concerns – namely regulatory spillover – were addressed, and that their residual powers of control over the merging firms were sufficient on a forward basis. It remains to be demonstrated, however, that the success of this innovations in minimizing any latent regulatory concerns was because those regulators were not in positions of dependency of the merging firms. The following discussion makes this relationship clear: because the overall level of regulatory dependency was low in the jurisdictions involved, the prescribed steps were indeed sufficient, as the costs associated with

the merger were not considered to be high enough to require more severely interventionist moves against the merger.

Importantly, it was a previous and long-standing SEC market structure policy that ensured that the exchanges would have to run separately-regulated and independently managed exchange platforms in America and Europe that made those SEC commitments palatable to European regulators. The SEC's stay-at-home promise was contingent upon the firms not merging their liquidity pools, offering a single listing platform, or seeking cross-jurisdictional trading screens. The single most important factor determining that this would be the case was an antecedent SEC policy stance regarding its National Market System, particularly that it would be a fully firewalled system, not subject to foreign competition for domestic exchanges (Fleckner et al., 2006; Posner 2009b; Anonymous Interview, Washington DC, November 15, 2012; Anonymous Interview, telephone, February 22, 2013).

While this is a highly technical issue, the most important feature of the SEC's decision is that foreign stock exchanges cannot directly access US market participants (there are of course several 'workarounds' for indirect access that foreign exchanges and intermediaries can make use of). Most securities regulators around the world have mechanisms or tools at their disposal referred to "mutual recognition", which as allows them to recognize and/or authorize foreign trading venues as being subject to equivalent regulations in their home jurisdictions, and therefore entitled to host market access without any additional regulatory requirements. Such an authorization gives foreign exchanges direct access to domestic market participants outside of their jurisdiction, and in some cases even allows domestic brokers and/or retail investors to become members of the foreign exchange.

There is – deliberately – no such provision in US law or the SEC’s toolkit for non-US exchanges, making it a major outlier vis-à-vis its global peers. A former official explained that a major reason for this market structure decision has been an effort to avoid a competitive disadvantage for US exchanges by putting them into direct competition with exchanges subject to rules other than the SEC’s stringent ones; the decision has the corollary effect of strengthening the SEC’s ability to achieve certain investor protection outcomes, because US investors can only directly participate on SEC-regulated exchanges (Anonymous Interview, telephone, February 22, 2013). Indeed, the impact of this market structure decision is very simple: US investors cannot become members of or directly participant on foreign equities exchanges, and can only trade in stocks that are directly regulated by the SEC. Foreign exchanges must become US exchanges for the SEC to allow US trading activity to take place on them on a direct basis. While this has been subject to extensive policy and academic debate (Tafara and Peterson, 2007), it remains the case to this date.

In the context of the NYSE-Euronext merger, the significance of this policy was that the NYSE would remain fully SEC regulated and an entirely American business unit, and Euronext, and its listed firms, would remain entirely distinct from (i.e., without direct access to) the US market and its investors. The implication was that the SEC’s investor protection mandate – which is what would drive it to impose Sarbanes-Oxley style regulations on European firms, in the minds of European regulators – was not triggered or threatened in any way by the merger, and the US authorities were not any more exposed to the merged firm than a solely US-centric firm to achieve their desired policy outputs. As long as US investors could not directly participate on the European exchanges, there was no reason for the SEC to impose its policies extraterritorially, nor was there any reason for the SEC to oppose the merger. (Anonymous

Interviews, Washington DC, November 14 and November 15, 2012). As one observer put it: “On these mergers, the US isn’t giving anything up. NMS is a closed system.” (Anonymous Interview, telephone, February 14, 2013). A former SEC official corroborated this view: “As it stands, NMS is a closed, ‘sealed’ system. [It is] not perfect but has settled on some rules and procedures”; as a result, the SEC was “confident that it could yank it [NYSE] back through regulation later on” (Anonymous Interview, Washington DC, November 14, 2012).

The overall result was that the SEC became comfortable with the merger. As an official explained, “the NYSE never thought it could sneak one by the SEC”: the exchange was not going to be able to push for a full liquidity pool merger, and as a result, “the SEC is not concerned, it’s not going to let it [a merger of the exchange platforms themselves] happen. Euronext is not going to be a regulated exchange in the US” (Anonymous Interview, Washington DC, November 15, 2012). A former official now working in the financial services industry put it more bluntly, given these fundamental residual SEC powers: “My basic view isn’t going to make you very happy – exchange mergers are not very important. It’s not an important investor protection issue. Why do we care about exchange mergers at all?” (Anonymous Interview, telephone, February 22, 2013). Another agreed, albeit less brusquely: “So basically this [merger] was really never a political issue – in fact there was a big push [within the SEC] not to stop it. These are businesses, and yes regulation has its place, but not to stop progress and businesses from evolving” (Anonymous Interview, telephone, March 18, 2013).

In sum, this historical policy choice relating to US market structure had a critical impact on the comfort levels of the European and US authorities with the merger. They believed that their ability to realize their policy goals would not be in any way affected by the merger and was in no way dependent on whether or not the firms merged, as a direct result of this SEC decision.

Indeed, this was reinforced in an important way by the incentives of the merging firms themselves—i.e., the SEC’s decision on foreign exchanges directly reduced both the US and European authorities’ dependence on those firms.

While the firms may have had an economic interest in reducing barriers to transatlantic listing and investing, they simultaneously had every incentive to do so within the territorial constraints imposed by the SEC. NYSE-Euronext did not want the SEC to impose SOX on their operations in Europe, as this would reduce the ability to encourage American and other global firms seeking public listings to move into non-American, SOX-free jurisdictions for listing services; it would also threaten the existing clients of the European exchanges, who had no interest in being subjected to costly American rules and might encourage them to de-list and seek alternative sources of capital. NYSE and Euronext would therefore actively avoid undertakings that threatened this core business logic of the merger as well as their core listing and trading business, a position that was understood on the European side of the proposals (Anonymous Interview, London, April 18, 2013). John Thain, then the CEO of NYSE, was remarkably candid about this in an interview with the Financial Times:

From my perspective, the ability to compete for international listings where companies don’t want to be subject to Sarbanes-Oxley is one of the big attractions of this transaction.

It would not make any sense for us to have the Sarbanes-Oxley provisions apply anywhere but in the US. (Authers et al., 2006)

Neither set of authorities would need to apply pressure on NYSE-Euronext to avoid certain cross-border undertakings that could lead to regulatory arbitrage or regulatory spillover, because the merging firms would simply avoid those transactions anyways. This was an important dynamic that would lead to compliance and enforcement costs for regulators that would be

remarkably similar to their status quo costs, as the firms' own interests reinforced the firewall that divided the SEC and Euronext authorities down the Atlantic.

**Additional measures of dependence.** Beyond this specific and crucial market structure policy in the US, the broader patterns of dependency in the US and Europe are also what the theory expects. More generally, public dependency on the US side, particularly the SEC's dependency on the NYSE, was significantly lower than in either Canada or Australia, as described in the previous chapter. First, the market structure for equities trading in the US was not as monopolistic as in many other markets, with the NASDAQ in particular providing an alternative listing and trading venue (NASDAQ also merged with a transatlantic counterpart, the Nordic OMX group, at about this time). Secondly, market structure reforms in the years preceding the NYSE-Euronext merger eroded the position of the NYSE. First, the SEC's Regulation ATS ("Alternative Trading System") implemented in 1998 authorized venues other than the incumbent stock exchanges to begin to execute trades in stocks listed on the incumbent exchanges. Over the next decade the development of the National Market System (culminating in Regulation NMS in 2007) further broke the power of the incumbent exchanges, especially by requiring "best execution" for trading, under which brokers must execute trades at the best available price, wherever that is made available rather than a preferred or incumbent venue (i.e., on any number of exchanges or ATS) (Gadinis, 2008a). As a result the market share of the NYSE and NASDAQ has plummeted over the last decade (Lee, 2010, pp. 58-59). Authorities are less dependent on the NYSE to provide the trading infrastructure that supports America's capital markets than their counterparts in Australia and Canada are on their large incumbent exchanges, and are therefore less concerned about the impacts of cross-border ownership on how

that infrastructure operates – a view corroborated in several interviews with current and former US officials who evinced polite but vocal confusion that the topic was of interest at all.

(Anonymous Interviews, telephone, February 22 and March 18, 2013; Washington DC, November 14 and November 15, 2012). As one put it, “[NYSE] doesn’t even have that much market share anymore” (Anonymous Interview, telephone, March 18, 2013).

On other key functions, such as the development of rules governing listings or trading, the SEC’s dependence on the exchanges has also waned. First, like in Canada, the NYSE and NASDAQ have outsourced many of their self-regulatory functions to a private and independent arms-length Self-Regulatory Organization (SRO) called the Financial Industry Regulatory authority, or FINRA. Notably, the SEC has taken a proactive role developing rules to govern this SRO – all FINRA rulemakings must be notified to and approved by the SEC, and the Agency has also established rules for FINRA’s corporate governance that have distanced the organization from the exchanges that fund it (Karmel, 2007). Moreover, key pieces of federal legislation, not least the Sarbanes-Oxley corporate governance reforms, have led to the “federalization” of authority over the rules governing publicly-traded companies (Dombalagian, 2006). Similarly, trading rules have been subsumed under Regulation NMS. Over the past several decades, the US federal state has absorbed much of the exchanges’ authority for many of the key rules governing the firms that are traded as well as trading itself, “making the stock exchanges more like subsidiaries of the [SEC] than the private clubs that they once were” in the words of one analyst (Fleckner, 2006, p. 2583; cf. Aggarwal et al., 2006). Another connected observer explains that the question of whether the merger has any impact due to the self-regulatory powers of the exchanges is

Almost moot because SEC has eliminated most of the [self regulatory] obligations: member regulation, best execution, are now regulated by Reg NMS. They still file trading rules. When they hadn't federalized SRO regulation, there was concern that if exchange fell into hands of [Deutsche boerse] or another, there would be a lot of pressure to change trading rules, business conduct rules. (Anonymous Interview, telephone, 14 February, 2013)

The key inference here is that, in the wake of a changed approach to self-regulation, those concerns have fallen away.

In Europe dependence on the Euronext exchanges was also low, but for different reasons. Approval from regulators came in two parts – from the multilateral College of Euronext Regulators, and from the Dutch Minister of Finance (because the Euronext holding company was registered as a Dutch company, commonly done for tax reasons). First, and most broadly, the exchanges were not central components of the market economies in these countries. Stakeholders in those countries explained that decision-makers were not particularly concerned about the role of the exchanges in delivering high-level market outcomes, but rather on their continued policymaking autonomy without interference from the SEC (Anonymous Interviews, Paris, May 21, 2013; Brussels, June 18, 2013; The Hague, 21 February, 2014). This is reflected in the overwhelming focus in European newspaper coverage on the role of the SEC and the potential for regulatory spillover from the US, particularly Sarbanes-Oxley rules (cf. Authers et al., 2006; Grant ,2006b, 2006c; Aggarwal et al., 2006). The College of Euronext Regulators represented securities market officials from countries whose capital markets, while developed, have not traditionally been the major source of funding for domestic enterprises (Zysman, 1983; Posner, 2009a). Of course the UK is an exception under this typology, but the London-based

exchange involved in this merger (LIFFE) is a derivatives marketplace with a global footprint, not a domestically-oriented stock market.

Second, the introduction of competition into securities markets – through the EU-level MiFID legislation referenced in the UK case, above – had the same impact in continental Europe as in the UK, breaking the monopoly of the incumbents, fragmenting trading across European markets, and disrupting the traditional role of the national exchanges as the primary trading infrastructure in their jurisdictions (Pan, 2007; Committee of European Securities Regulators, 2009).

Third, in terms of the allocation of regulatory structure, European officials had already lost their exclusive oversight of the exchanges, and with it their monopolistic ability to steer those exchanges towards national regulatory, market, or even policy priorities. Euronext had previously consolidated several national exchanges in a single European firm, five years earlier, and as discussed, it was coincident with the introduction of the Euro and seen by many as a market-side complement to the political agenda of European capital market integration – going further to harmonize many micro-level rules than national authorities could, for political reasons (Shipp, 2007; Clausen and Sorensen, 2009; Anonymous Interview, Paris, May 21, 2013). The firm produced a harmonized Euronext rulebook that, far from increasing any individual regulator’s dependence on the firm, actually served to lessen it by standardizing most rules across multiple European markets and reducing each regulator’s autonomy. This standardization also took place within the context of EU-level Directives (Market Abuse, Prospectus, Transparency, as well as MiFID) that provided the basis for an EU-wide capital market with cross-border “passports” for securities markets participants (Quaglia, 2007). Furthermore, as a part of that previous merger, national securities regulators had already joined a cross-border

regulatory structure (the College) that diluted their exclusive control over each component of the exchange firm. This meant that the NYSE-Euronext merger presented few additional marginal costs, even within the context of an already-low level of absolute regulatory dependency on the firm.

Lastly, it is worth noting that the NYSE-Euronext merger could have been viewed as helping market officials deliver on key policy goals at the time, including the harmonization of the transatlantic market (Tafara, 2004), with officials at this time dedicating energy towards the reconciliation of US and European accounting rules (Fleckner, 2008), and even the possible ‘mutual recognition’ of similarly-regulated markets and market participants (Tafara and Peterson, 2007). None of these policy initiatives were advanced in any material way by the merger and most of stalled (not least because of European concerns about SOX, which also played into the merger proposal), but in speeches at the time, many officials – including SEC Commissioners – saw the mergers as a step towards greater transatlantic market and regulatory integration. Chairman Christopher Cox, for instance, noted in a speech in June 2006 that,

If the current round of mergers of exchanges eventually facilitates mergers of the central securities depositories associated with the exchanges, they could have an even greater impact by significantly reducing settlement costs. These same benefits could be available to American issuers and investors if U.S. exchanges are combined with those in other nations. Inevitably, our parochial national market system will give way to the reality of a global market, because the only truly closed economy is the world economy. In the not-too-distant future, investors half a world away will be able to buy U.S. stocks during their own business hours, and in their local currency. And American investors will undoubtedly

have cheaper access than today to stocks in foreign markets. (United States Securities and Exchange Commission, 2006)

In France, some observers (although not all) suggested that by linking up with New York, officials foresaw a competitive advantage for Paris in a period of increasing integration and competition between European financial centres if it could tie itself to the largest and deepest capital market in the world (Callaghan and Lagneau-Ymonet, 2012; Anonymous Interviews, Paris, May 21 and May 22, 2013). It was understood that the CEO of Euronext at the time, Jean Francois Theodore, was a particular proponent of this view – a view that may even have carried more weight in certain policy circles than President Chirac’s alternative vision of a pan-European bourse. In brief, while tangential to the main theoretical claims being advanced in this chapter, it is worth noting that in some ways the mergers were far from inimical to the policy interests of major (namely US) regulators. They could even be seen as complementary. This broadly corroborates the assumption that regulators primarily see mergers through the lens of their ongoing public policy book of work.

### **Shadow case: NASDAQ-OMX**

It is worthwhile to briefly remark on a concurrent transatlantic merger involving a European and American firm - the merger between NASDAQ and OMX, the latter a pan-Nordic conglomerate and based in Stockholm. Given that NASDAQ was discussed in the previous case it is appropriate to consider its case to the extent possible. This merger was proposed in May 2007, but became subject at a high level to the same European regulatory concerns as the NYSE-Euronext merger.

Without interview data to rely on, this merger is difficult to analyze in detail for the degree to which it followed the expected process. It was also not widely reported on or analyzed in the financial press – in fact, there are only a short number of media reports on the subject as the NYSE-Euronext merger commanded more attention. However, the few details that are publicly available are consistent with the observations that would be expected.

Critically, Swedish authorities expressed similar concerns to the Euronext authorities. In particular, the financial markets authority publicly stated that it did not want a merger between NASDAQ and OMX to “alter the Swedish model” and thereby undermine Sweden’s competitiveness, through the imposition of SEC-style or direct SEC regulations on the Swedish market. As the Minister for Financial Markets at the time, Mats Odell, stated: “the rules we have are more European, based on European directives. We are planning to implement more European directives. We don’t want this deal to mean that it will be harder to raise risk capital” (Ibison, 2007). At the time, Sweden’s market policymakers were seeking to ensure that Stockholm was a desirable and easy place for companies to raise capital in Europe. Odell thus called for a panel of eminent persons to investigate and report on the proposal – although no report is publicly available or even referred to in financial reporting. It is highly plausible that the same set of rules and firm-based incentives that assuaged the Euronext regulators had an impact on the Swedish authorities’ decision to approve the merger. The deal received approval and was completed by February 2008.

While clearly a limited discussion, it appears that NASDAQ-OMX triggered what were essentially the same regulatory concerns as the NYSE-Euronext merger – which is not surprising, given that they were nearly concurrent and, on the US side, being assessed by the same markets authority. This discussion therefore reinforces, at a high level, the validity of the

some of the theory's key expected observations – particularly the cost-based concerns that motivate regulators and the general market structure variables that condition dependency.

### **ICE – NYSE-Euronext: a merger with conditions**

In July and August of 2013, an Atlanta-based derivatives exchange company, the InterContinental Exchange (ICE), received approval from the European Commission and American regulators for its \$10.9 billion takeover of NYSE-Euronext.

On the American side, the deal did not present any new or discrete cross-border challenges because the NYSE was already part of an international group, and ICE was itself an American exchange firm (albeit one with operating interests in Canada and London already). In addition, because ICE is a derivatives exchange and NYSE a stock exchange, there were no fundamental market structure implications for the US authorities to become concerned about, and the deal was not subject to either political scrutiny or even substantial media coverage – although the ‘upstart’ nature of ICE commanded some attention. This is not surprising or puzzling, given the SEC's positive approach to previous merger proposals involving NYSE for reasons already

The positive decision in Europe was more closely scrutinized by the press, particularly the fact that the European Competition Commissioner (DG Comp) approved the deal despite blocking a merger between NYSE-Euronext and German group Deutsche Boerse the previous year (the DG Comp decision on DB-NYSE-Euronext is the subject of the next chapter). The market structure implications of the merger, particularly for the commodity derivatives market, were determined to be non-material by the European authorities, allowing the deal to go through.

This was rightly described in the financial press as most “significant obstacle” the merger proposal had to overcome (Fontanella-Khan et al., 2013).

At the same time, most accounts of the merger missed an important political process in Europe that accompanied the deal-making and its approval, and in fact took several more months to come to a conclusion. The deal was subject to a notable set of political conditions – conditions that did not become highly politicized because they complemented the goals that ICE had for NYSE-Euronext.

ICE is a derivatives exchange and its primary focus in launching a takeover bid for NYSE-Euronext was not to acquire the stock exchange units on either the US or European side (NYSE or Euronext), but instead to acquire the London-based derivatives exchange LIFFE, which it subsequently absorbed into its existing London-based ICE Futures Europe platform. In fact, ICE did not have a particular desire to gain ownership and control of the listed stock businesses run by Euronext. It was seeking synergies for its existing business lines – and attempting to compete with American giant CME Group – rather than expand into the stock market business.

Beyond the DG Comp approval that ICE received in the summer of 2013, ICE also needed to gain approval from the market authorities in each of the jurisdictions Euronext operates in. In France and, to a lesser extent, in the Netherlands, public officials tied their approval of the merger to ICE’s commitment to divest itself of Euronext in a timely fashion and return it to control by key European shareholders and stakeholders. What explains this move to “re-nationalize” (albeit through the market) Euronext on the part of key European jurisdictions?

In a 2013 report that was commissioned by the French Trésor, a French official named Thierry Francq laid out a “post-merger” vision for the future of Euronext, which involved a

broad based ownership by large European financial service firms constituting no less than 25% of total shares (Francq, 2013). The merger with ICE, according to Francq, “constitutes an opportunity for Euronext to develop services in the places where it operates and to play a key role in the desired organization of the market and post-market infrastructures in Europe and the Eurozone in particular” (Stafford and Carnegie, 2013). The Francq report was endorsed by the French Finance Minister, Pierre Moscovici, who similarly voiced support for the ICE takeover on the grounds that Euronext had divested.

More clearly stated, the merger would allow European policymakers to reassert their control over Euronext at a time when the broader structure and health of European capital markets was increasing in salience as a policy issue. As the financial crisis waned and it became clear that continental banks would soon come under additional rules and regulations – particularly as the global Basel III standards were being developed – policymakers recognized that this could hamper banks’ ability to lend into the real economy. This is driven by the fact that banks are increasingly required to reduce their overall leverage and to hold more regulatory capital against their exposures: they will simply have less cash to loan going forward. This puts pressure on small and mid-size enterprises that commercial credit – a key driver of economic growth – and that have traditionally depended on banks for that credit in the continental European economies where Euronext operates (cf. Zysman, 1983). While European policymakers had before tried to diversify Europe’s capital market structure away from a bank-dominated one and encouraged the growth of new stock markets (Posner, 2009a), and had failed, the post-crisis credit pressures facing banks and the real economy compelled those same policymakers to undertake another effort.

An official described the policy discussion about the need for a newly European-focused exchange in an interview in Paris: “Naturally, NYSE-Euronext is not concentrated on these companies [SMEs], and it's a challenge to move the situation, especially for a big company like NYSE-Euronext.” While this particular official did not think Euronext was the appropriate option to pursue these new policies and projects, and was speaking before the Francq report was released, he recognized that it was a critical policy issue in French capital market circles: “[ICE] is not interested in all in Euronext... Now there is a discussion in France - how to think about infrastructure, and how to finance our economy.” (Anonymous Interview, Paris, May 21, 2013). These views were also held in Amsterdam, as explained by a senior Euronext official:

Looking down the road... politically, politicians see that the exchange is a socially responsible platform, and it needs to step in and fill that role, as they did for the last 400 years. There will be a new role for banks in Europe. Banks are being overregulated to roll back to domestic framing of their activities. Exchanges are a part of that process. Companies should list, attract capital, grow as it always has been. That's the sensitivity in every country... This is the concern of Dutch politicians and the regulator. They're happy with 'back to Europe' for the exchange, but we want to see European consolidation, not another level down, the domestic level. (Anonymous Interview, Amsterdam, February 20, 2014)

This series of policy initiatives placed Euronext, position as an incumbent and liquid exchange group with ties to investors in multiple markets, in a privileged position. The French market authority, the AMF, was blunt about the impact of Francq's report in how it approved its approval for the deal. In an official newsletter, the AMF described its decision-making— and that of the Minister for the Economy, who the AMF advised to approve the deal – as follows:

In France the tie-up, which required a change in indirect control of the market operator Euronext Paris, was approved by the Minister for the Economy, after consultation with the AMF and after considering . . . Thierry Francq's report on Euronext's development and the future of trading and post trading activities in Europe. The AMF and the committee of regulators made sure the transaction would not interfere with the orderly functioning of Euronext's markets and that these markets would still have adequate human, technical and financial resources, having obtained commitments from ICE to that effect.

As soon as its acquisition plan was announced in December 2012, ICE disclosed its intention to spin off Euronext's continental markets. ICE has since confirmed these plans, which it expects to finalise in mid- 2014. The various regulators involved, including the AMF, will examine the details of this second transaction. The AMF will pay particular attention to the resources, financial forecasts and strategy that will be proposed for Euronext and that will ensure the future viability of the group's French regulated markets. The AMF will also closely monitor the change in ownership structure, another factor that is key to the market operator's stability and sustainability. The committee of regulators has also asked ICE to maintain a minimum holding of 25% in Euronext, until other major shareholders acquire some or all of this stake. (Autorité des marchés financiers, 2014)

The discussion of this latest merger involving Euronext was not designed to test the theory as rigorously as has been done in previous cases; rather, the purpose here has been to highlight what types of regulatory politics emerge as conditions of dependence change over time. In the post crisis period, a key variable in the European continental economies has changed – that is, degree to which market authorities are dependent on stock exchanges to help them build deep and liquid European capital markets in lieu of maintaining a bank-driven funding model. The

extent to which France or other jurisdictions move away from this established system is of course an open empirical question at this juncture: the European Commission is presently pursuing a “Capital Markets Union” agenda with greater securitization options, and more intra-European cross-border transacting at its core, but it faces significant challenges in doing so.

The policy challenge of changing European markets does not, however, subtract from the increased value that market authorities and their political masters saw in Euronext – and, in particular, in a re-Europeanized Euronext – at the time of its merger with ICE, in 2013. As a result (and, it must be reiterated, in a manner that was generally consistent with ICE’s own preferences for the deal), the Euronext authorities placed conditions on ICE’s takeover of Euronext that enabled them to achieve their own policy goals at the time. The merger with ICE came at a juncture where Euronext’s overseers had received a mandate to deliver better capital-raising opportunities for European SMEs. As a result, those overseers found themselves newly-dependent on the exchange to deliver those capital-raising opportunities. This final, concluding discussion demonstrates that the merger decision itself became subject to those political concerns emanating from new and changed policy dependencies.

### **Conclusion**

In this chapter the degree to which the theory of regulator dependence explains outcomes where the key variable – dependence – takes on different values over time is tested across three episodes involving the Euronext change. In general, the theory withstands this dynamic test. In particular, the observation that greater degrees of dependence in the post-crisis period – as a result of stiffer banking rules and the need for alternative sources of funding – led to an re-nationalizing effort on the part of European regulators is unexpected given the previous

trajectory of European decision making regarding Euronext, but entirely predicted by the theory of regulator dependence. This is a fascinating and important empirical finding.

On the primary case – the NYSE-Euronext merger – the theory is better able to explain outcomes than the relevant alternative explanations, namely:

- The ability of political leaders (such as Jacques Chirac) and business interests to pressure French regulators seems significantly circumscribed by the lack of unified interests at the highest level of French policymaking and interest group mobilization; the concerns of Dutch firms ought to have created pressure against the merger, but it was actively approved. In the Netherlands and the US, it is difficult to observe or infer the presence of material political or business interference. In general, it is difficult to ascribe meaningful causal power to the preferences of actors beyond the regulators who approved the deal.
- The ability of institutionally-derived typologies – particularly the Varieties of Capitalism approach – to explain this merger outcome is limited. The US approves the merger, as is expected as jurisdiction with a liberal approach to corporate governance and the market for corporate control – however, the French authorities do not adhere to either the predicted behavior for a *dirigiste* type economy, or their own traditionally-interventionist pattern of behaviour (Callaghan and Lagneau-Ymonet, 2012; Callaghan, 2014).
- Finally, a systemic explanation that explains the French decision to approve the merger by reference to the high opportunity costs of not bandwagoning with a wealthy and powerful foreign market is plausible: however, it runs contrary to the observation in the previous chapter that small markets weigh those

opportunity costs less heavily than the potential costs of integration from a mercantilist perspective: i.e., the potential loss of business, revenue, and even prestige to the larger economy in the merging dyad. In short, the observations here are the converse of those in the previous chapter that pointed to a Stolper-Samuelson based explanation.

Against these shortcomings, the theory of regulator dependence receives a high degree of empirical support in the primary case studied in this chapter, as summarized in Table 6. Each of the necessary scope conditions for the causal logic of the theory to obtain are present in all three of the jurisdictions subjected to rigorous analysis in this chapter: in France, the Netherlands, and the US, the expected levels of insulation are observed and, critically, regulators' concerns about the costs to their oversight present real challenges in the context of their decision to block or approve the merger. However, the positive outcomes from a regulatory perspective are crucial, because they are directly related to the manner in which both market and regulatory power had previously developed in those jurisdictions: not least that regulatory authority had previously been allocated in a manner such that the merger did not present any additional costs that they would not support, and alternative financing mechanisms were available in the domestic economic systems.

The next chapter moves to test the theory in a particularly challenging manner: by considering it where a market structure authority rather than a market regulator is responsible for blocking a merger, under conditions where significant lobbying is observed, and at a supra-national level (i.e., in the EU).

Table 6:

*Summary of observations relating to NYSE-Euronext*

<b>Jurisdiction</b>	<b>O1: Regulators’ insulation</b>	<b>O2: Regulators’ concerns about costs</b>	<b>O3: Regulators’ response</b>	<b>O4: Regulators’ dependence</b>
France	High – key political and business constituents do not see their preferences realized	Significant but managed – potential regulatory spillover addressed by ‘Stichting’ arrangement	Positive - Approval	Low – previous cross-border integration plus bank dominated financing providing competition for services
Netherlands	High – no notable political interference; business concerns are addressed in context of approval	Significant but managed – potential regulatory spillover addressed by ‘Stichting’ arrangement	Positive - Approval	Low – previous cross-border integration plus bank dominated financing providing competition for services
United States	High – no notable political or business interference	Not significant as addressed by previous market structure decisions ensuring a ‘firewall’	Positive - Approval	Low – previous scaling back of self-regulation and introduction of competition

## **CHAPTER VII**

### **DEUTSCHE BOERSE – NYSE-EURONEXT: A HARD TEST OF THE THEORY OF REGULATOR DEPENDENCE**

#### **Introduction**

On 1 February 2012, the European Commission's Competition Commissioner, Joaquin Almunia, announced his decision to block the proposed merger between Deutsche boerse (DB) and NYSE-Euronext, announced the previous year. The merger would have created an entity that, at the time, would have been the largest exchange firm in the world, with annual revenues in excess of €5 billion and a market capitalization of over €17 billion (Valiente, 2011, p.2). The European Commission's decision ended up revolving around the fact that both firms not only operated large stock markets (NYSE and DB), but also owned derivatives exchanges: NYSE-Euronext owned the London International Financial Futures and Options Exchange, or LIFFE, and DB owned Eurex as well as an eponymous central counterparty (clearing house). The merger thus presented authorities with a dilemma between choosing the benefits of consolidation in the derivatives industry – not least its beneficial impacts on liquidity and the use of collateral – and maintaining competition in a key and growing market. Indeed, the EU's competition authority attempted to have it both ways, presenting the merging parties with a series of 'remedies' that they could implement in order to secure approval, including certain guarantees of access for third parties and divestment of particular business interests. DB and NYSE-Euronext demurred, and the merger was blocked.

In the context of this dissertation, this episode presents a substantial and hard test for the theory. It is a particularly challenging test for three reasons.

First, in terms of policymaker insulation, the merger was subject to a high degree of interest group lobbying. As a result, it challenges the theory's requirement that decision-makers are insulated and acting on the basis of their own *sui generis* preferences to effectively execute their policy goals.

Second, in terms of the cost-based logic for merger outcomes, the decision was made and enforced by the European competition authority, not by a veto-wielding market regulator. This means that it challenges the theory's prediction that merger decisions are driven by their impact on market authorities' policy goals in the capital markets.

Third, with regards to the impact of dependence, the case is itself a market structure decision point of theoretical significance, because it is the type of decision that is theorized to give rise to dependence at a later date. As a result, two types of evidence may be observed: as in all cases, previous policy decisions leading to regulator dependency and informing the merger outcome should be observable; and unique to this case, evidence that officials considered the impacts this merger would have on their relationship with the firm, i.e, their own potential dependency if the merger was allowed to go through, may also be observed. Indeed, the observation of this latter consideration would be strong confirmation of the theory of regulator dependence, because it would show its logic operating not only in merger decisions, but also at the key "historical" junctures where regulatory relationships with important market infrastructure firms are shaped.

The findings in this chapter are broadly consistent with the expectations generated by the theory, although they are not absolute. A significant degree of insulation can be reasonably inferred, and the cost-based logic for the merger decision is apparent in the approach taken by the EU competition authorities in conjunction with their colleagues elsewhere in the European

Commission, who were pursuing policy reforms that were implicated in the merger: they considered that creating a transatlantic exchange conglomerate in derivatives would make it more difficult for them to pursue the derivatives market policy initiatives that they were concurrently undertaking. Moreover, historical policy developments leading to this dependency are identifiable, as well as considerations on the part of European Commission officials about the impact of the merger on their future and on-going relationship with the firm. At the same time, the evidence is not absolute: it is plausible that lobbying activity explains some of the outcome, particularly the potential influence of EU Member States who acted (or, crucially, did not act) in ways that reflected their preferences over the outcome. This important caveat – i.e., the German “dog that didn’t bark” – should be weighed against the rest of the evidence presented here, which is otherwise roundly supportive of the theory’s predictions.

The most significant finding of the chapter, however, is that even in a hard test where the process evidence does not perfectly meet the expectations of the theory – notably, that market regulators drive outcomes on merger decisions – a more nuanced investigation yields the clear finding that, indeed, market regulators’ fingerprints can be found all over the European Commission’s move to block the case. In particular, the relationship between the Commission’s competition and market Directorates points clearly to the sharing of views and, crucially, concerns about the merger’s impact on broader and contemporaneous Commission policymaking’ efforts. Perhaps even more notably, disagreements that emerged between the merging firms and important actors in the Commission’s market directorate not only related to the discrete market structure effects of the merger, but also the way in which the proposal did (or did not) present challenges and therefore costs to the realization of the contemporary European policy agenda. Stakeholders on all sides spoke about this merger in terms of its implications for

the Commission's market regulation efforts. As a result – and despite important caveats identified in the chapter – key inferences relating to the causal significance of the Commission's *market regulation* activities, and the concerns that the merger generated from that policy-delivery perspective, can be made in this case.

The chapter proceeds in three parts: it considers the European Commission's degree of insulation from political influence with regards to this policy decision; establishes how the merger would have generated costs in the context of the broader European Commission market reform program; and finally identifies both the historical policy outcomes that influenced the merger decision as well as the considerations made by officials at what was, itself, an important historical policy juncture.

### **Institutional context: the relevant actors in the European Commission**

It is important, before proceeding to test the logic of the theory against this case, to establish the institutions that were relevant in the merger episode, namely the European Commission's internal markets and competition directorates. The European Commission (EC) serves as the executive function of the European Union and, importantly, it is the only EU body with the capacity to initiate legislation by drafting proposals that subsequently become European law (although final drafting is accomplished through a 'trilogue' process with the Council and Parliament). The Commission often delegates technical rulemaking to European supervisory Authorities like the Paris-based European Securities Markets Authority, but must then endorse the rules made under European legislation, and has a veto over these rules that it does exercise. The Commission's body of legislative work includes critical pieces of financial markets regulation that have generally sought to integrate and harmonize European rules for the capital

markets, notably the 2007 Markets in Financial Instruments Directive (MiFID) and the post-crisis recast version of MiFID that was finalized in 2014 and is known as ‘MiFID II’; as well as the 2012 European Markets Infrastructure Directive (EMIR), which implemented many of the post-financial crisis reforms to over-the-counter derivative markets that were agreed at the global level. Until recently, the design and implementation of these high-level rules for the capital markets were the purview of the Internal Market and Services Directorate General (DG MARKET), although the most recent European Commission President, Jean-Claude Juncker, has hived off financial services into a separate Directorate-General for Financial Stability, Financial Services and Capital Markets Union, or DG FISMA.

Separately, the EC’s Directorate General for Competition (DG COMP) has become the institution most responsible for investigating and issuing judgments on merger proposals (as well as related issues, including tax policy and other potential distortions to a ‘level playing field’ in a product market) involving European firms with an anticipated impact on European market structure. It now takes the initiative on cases that would formerly have fallen under the purview of national authorities, and its decisions are binding under the Treaty on the Functioning of the EU.

Each of these EC competencies is relevant in this particular case, both in terms of understanding how the EC ultimately decided on the merger, as well as determining both the intra-EC political dynamics and broader, multi-level European political dynamics that informed the outcome. In particular, it is this intra-EC dynamic that is most salient and important, not least the degree to which the DG COMP decision serviced to reinforce political priorities for market regulation that were being pursued elsewhere in the Commission.

## **A competition authority weighs in: Blocking DB – NYSE-Euronext**

### **Assessing the EU competition authority's insulation**

It is first necessary to identify the relative insulation of DG COMP from external political influence in its decision on DB – NYSE-Euronext. The potential sources of external political interference are twofold: from Member States' national capitals, and from corporate lobbying. Because this was a highly politicized episode, and subject to intense lobbying, it is important to expend some effort in demonstrating DG COMP's relative degree of independence in reaching this decision. The degree to which DG COMP was insulated from political pressure from Member States and organized private sector interests on this decision is demonstrated both in terms of its formal constitution as well as informal, off-the-record confirmation of the degree of its independence.

The political independence of Europe's competition authority is not absolute. Fundamentally, the post of Commissioner – like all European Commission appointments – is political in nature, and as such the choice of leadership is given to the various types of politicization and horse-trading across EU Member States that such a process entails. However, to a significant extent this potential politicization of DG COMP's leadership is mitigated by the processes and transparency – both statutory and 'soft' – that the staff level is subsequently subject to, as documented by Monti (2014). This keeps the potential influence of Member States (and particularly those national capitals that have a role to play in the appointment of the Competition Commissioner) at bay. As Monti explains, DG COMP staff investigating market structure issues both follow formal institutional strictures as well as informal guidance relating to conflicts of interest and political involvement – as he summarizes it,

The officers of DG COMP remain relatively immune from improper interference, and a number of mechanisms are in place to fend off political interference: first the Council of Ministers [i.e., Member States] plays a limited role, because the Treaty provisions and the Merger Regulation leave the detailed work to DG COMP; second the Commission has published a number of soft law notices describing how the Commission carries out its tasks. (Monti, 2014, p. 10)

Second, it is important to note that, on both non-contentious and on controversial decisions, the European College of Commissioners (which is a veto-capable institution comprising the leadership of each of the EC's separate directorates general) takes a vote either in favour or against the proposed DG COMP decision. While this could have the effect of introducing a new political layer into the merger review decision-making process, in reality the "vast majority of cases" are voted on in a pro forma manner, by written procedure (Monti, 2014, p. 9). It is only on controversial cases where the College gathers to exchange oral views. It is important to note that the case under examination in this chapter was indeed subject to such an oral inquiry by the College, particularly due to a public disagreement between the Commissioners for DG COMP and DG MARKT – as is analyzed below. In this instance, the process through which alternative views were aired – and the ultimate decision to block the merger, i.e., uphold DG COMP's informed decision – provides a transparent record of the general independence of DG COMP in coming to its decision, and its capacity for rendering judgments free from improper external political influence even in controversial cases. The transparency of that record is important in the empirical discussion, below, inasmuch as the directorate's leadership is clear about both the market structure-based reasoning for its decision

on DB-NYSE-Euronext as well as (rather uniquely for a competition decision) its disposition towards the lobbying it faced on this case.

Finally, the degree to which DG COMP is open to private influence in its decision-making stems largely from the fact it formally takes evidence from market participants as it is undertaking its review. However, this private influence is a) often sought by DG COMP itself as it studies the various impacts a given merger is likely to have, and is therefore well understood by staff to be informed by the relative position of self-interested stakeholders in the market, and b) rationalized, to the extent that each party's assertions are tested against the same set of market data and weighed accordingly (cf. Monti, 2014). Their influence is therefore benchmarked against other firms' arguments as well as the same set of freely-available product market data. Firms are welcome to provide new analyses and broader policy arguments on that back of that data, but they are significantly less able to manipulate empirical facts to suit their commercial perspectives.

Off-the-record, individuals close to the merger proposal confirmed these general expectations of independence, in particular with reference to the extent to which DG COMP did not face significant and on-going interference from Member States.

Notably, the preferences of important Member States diverged, and they were not equally involved in the proposal. The key states were Germany, France, and the UK, both in terms of their stake in the merger and their influence on policy direction in Brussels (The UK's stake is perhaps less immediately obvious: both the City of London's pre-eminence as a European financial centre and what was then still called the LIFFE derivatives exchange – located in London but owned by NYSE-Euronext – were the elements driving British interest).

As one observer close to the merger explained it, these three states were divided in terms of the direction of their preferences. France remained neutral and did not actively engage one way or the other; Germany was, at least initially, tacitly supportive of the merger; and the UK opposed it, as it worried about the centre of European capital market gravity moving to Frankfurt as a result of the deal. However, the same observer explained that German support for the deal in particular was never made obvious, and it was never brought to bear on the Commission as a political consideration: “There were real issues around competition and then the German dog didn't bark... the German lobbying is usually formidable” (Anonymous Interview, Brussels, June 18, 2013).

Interestingly, interviewees aired somewhat contradictory views on the intensity and effectiveness of British opposition to the merger: while that opposition was certainly noted by both private stakeholders and officials, and one former DG COMP official described the British as doing “enormous behind the scenes lobbying”, the same official also suggested Member States were only involved when asked for their opinion on the deal (Anonymous Interview, Brussels, December 5, 2013); multiple interviewees suggested that British opposition took shape in the formal work done by the London Stock Exchange and NASDAQ (an American firm aligned with the LSE position given its business interests in Europe) in presenting data and arguments to DG COMP that pushed back against the case for the merger (Anonymous Interviews, Brussels, June 18 and December 5, 2013).

These observations on the relative silence of key Member States are broadly corroborated by details given in other interviews, including by a former DG COMP official, who explained that,

Somehow, for whatever reason, the governments were very comfortable with us going into prohibition mode. Maybe they were more uncomfortable with the possibility of Americans taking over than they were with keeping up their rivalry with London – I don't know. But they didn't lobby either way – contrary to the expectations of the parties. So it was very easy to prohibit. (Anonymous Interview, Brussels, December 5, 2013)

A separate Commission official from outside DG COMP remarked similarly that “I think what is most striking about this episode is that from a national interest view there was a notable silence” (Anonymous Interview, Brussels, December 5, 2013).

An individual close to the deal explained the relative German silence in the context of the broader Eurozone crisis gripping Europe at the time:

The crisis also meant that there was so much just living from day to day...this explains Germany - there was a German opportunity to weigh in, but the importance of the deal really slipped down the agenda. - It's like polling - if you polled the political class if they were in favour, many would have said yes, but that doesn't measure the intensity of German interest... it was hard to get traction - Merkel had a huge agenda, and the merger was simply not high up there. (Anonymous Interview, Brussels, May 27, 2013)

Other stakeholders noted that the German position changed throughout the merger, from one of light support to silence and disengagement (perhaps driven by local, union-driven concerns in Frankfurt that must be noted) – but that in neither phase was there a concerted effort from the Merkel administration to influence the outcome of the deal (Anonymous Interviews, Brussels, May 27 and May 28, 2013). Similarly, a Commission official from outside DG COMP noted that Germany did not intervene, and also argued that this and the final decision pointed to the de-politicized nature of the final policy decision:

Everyone thought it was good that Merkel didn't make the call on this. [DG COMP] is very much a world of itself – and they were completely independent in their assessment. Everyone was full of praise for the DG Comp team on this. If it had bowed to the pressures it wouldn't be credible. Plus, if this ends up being a political call, there would be a call for overhaul of COMP – it needs to be completely independent from the College [of Commissioners, i.e., the political level]. (Anonymous Interview, Brussels, June 10, 2013).

Based on these views on the lobbying of Member States that were worried about the distributional implications of the merger case, it is not entirely clear that standard distributional politics did not play a causal role – or could not be reasonably inferred to have played such a role in the counterfactual scenario where Germany waded in. The implications of this are twofold: first, that despite this important caveat the full counterfactual is unknowable, and the probable impact of a German intervention in favour of the deal can only be flagged rather than presupposed; and second, the fact that UK interests coincided with the verdict is not the same, causally, as the UK successfully lobbying against the merger. Again, the counterfactual claim – that absent UK lobbying the merger would have been approved – is difficult to sustain given the weight of evidence below about both the market structure and market regulation implications of the merger from the Commission's perspective. Indeed, the overriding conclusion from this discussion is that stakeholders were ambiguous and disagreed with each other about the extent of Member State lobbying, and even on the extent to which lobbying is generally an expected and potent factor in DG COMP decision-making episodes: it is difficult to infer clearly just how much insulation DG COMP had in this case or on any case, although it should be noted that it rarely blocks mergers (Thatcher, 2014; as discussed below), which suggests a high bar for action

(and one not motivated by political imperatives alone). Moreover, the reasoning behind DG COMP's decision remains based in sound empirical data that notably (and as discussed below) contradict the policy preferences of other major stakeholders. To chalk up the entire decision to UK power is to miss these many mitigating factors. That being said, it remains true that this discussion does not present bona fide evidence of insulation from Member States. As a direct result, this case continues to present a challenge to the theory and it is, on the basis of this discussion, even more important to show that discrete regulator-level concerns had an effect on the final DG COMP verdict – as is anticipated by the theory and is demonstrated below.

It is even more difficult to assert that the private sector lobbying on this case was not causally significant with regards to the outcome, because – as many observers noted – the lobbying was very active and very public in nature. As one anonymous Commission official explained,

It is not unheard of, and not illegitimate to talk to the whole [College of Commissioners], or the Commission [staff], in order to do some informing or explaining of key issues. This is important for how decisions are made. But this lobbying was a greater scale than we have ever seen before. There was more of it – there was a full page letter in the paper!  
(Anonymous Interview, Brussels, June 10, 2013)

In what ways, then, was this lobbying ineffective? First and most obviously is the direction of the lobbying efforts themselves. While the two parties to the merger – Deutsche boerse and NYSE-Euronext – came out strongly after the initial announcement, the broader financial service industry was divided on the benefits of the deal and advocated as such. For instance, other exchange firms, including US-based CME Group, ICE, and NASDAQ, as well as UK-based LSE all expressed concerns about the merger (ICE and NASDAQ then teamed up to

launch a failed counterbid for NYSE-Euronext) (Weitzman, 2011). Perhaps more surprisingly, though, is that many of the most important users of exchanges actually voiced some support for the merger in their petitions to the Commission – most notably the Association for Financial Markets in Europe, the powerful European arm of a global umbrella group representing investment banks, as well as the European Principal Traders Association, which represents the interests of ‘proprietary’ high-frequency trading firms (i.e., firms that trade on their own accounts rather than using client money). A former DG COMP official also noted that French trading firms had sent positive letters in support of the deal to the Commission (Anonymous Interview, Brussels, December 5, 2013). In voicing this support, stakeholders acknowledged that certain remedies would be needed to alleviate particular concerns about fees or pricing, but also pointed to the potential benefits the deal would present to end users. This demonstrates that the potential synergies available from a tie up were attractive to key, powerful constituencies in the financial service industry – in the words of one journalist, “market participants are not unanimous in their distaste” for lesser competition in the exchange space (Grant, 2011)

Even the merging parties themselves were not fully aligned from start to finish. As competition concerns were made known to DB and NYSE-Euronext by Commission staff, and ‘remedies’ were identified that the parties could pursue to satisfy the anti-trust concerns that DG COMP identified, several observers noted that DB in particular began to take a back seat and lobby less intensively for the merger to succeed (Anonymous Interview, Brussels, May 27, 2013) – one observer said pointedly that “DB lost faith or interest a little bit, actually well before the prohibition - this was in September or October. They were clearly moving on” (Anonymous Interview, Brussels, May 28, 2013). An official went further: “There were differences within the merger itself, and the lobbying was coming differently from both sides. They were

negotiating differently, and with German [DB] positioning changing...it was more vociferous from one side than the other side” (Anonymous Interview, Brussels, May 27, 2013). In short, as the economics of the deal changed, so too did the degree to which both sides of the merger were pressing the Commission for it to be approved.

There is considerable evidence, too, that the public nature of the lobbying campaign by the pro-merger camp actually backfired, and in some ways drove DG COMP and the broader Commission to scrutinize the merits of the merger even more closely. Indeed, the formal review document addresses all of the lobbying claims made by the pro-merger camp and debunks them systematically, which, as noted by a close observer of the proceedings, was an “unusual” thing for DG COMP to do (Anonymous Interview, Brussels, May 28, 2013). Furthermore, in the minutes from the College of Commissioners’ vote on the decision, it is obvious that DG COMP Commissioner Almunia took the opportunity of the meeting to address the efforts of the merging parties to engage in a public relations campaign through the press, which did not have an impact on his institution’s final judgment: as it states rather dryly in the official minutes, “[w]ith regard to the ‘leaks’ to the press and the question of their source, Mr ALMUNIA [sic] highlighted the very powerful lobbying campaign run by the two groups” (European Commission, 2012a). In an interview with the Financial Times, Almunia expanded on his view of the ineffectiveness of the lobbying effort: “They tried a public relations campaign, lobbying, political pressure to get a positive decision. I told them from the beginning: ‘you don’t know how to deal with the Commission.’ This is not the best way to convince us – quite the opposite – it is the wrong way” (Barker, 2012a). This view was backed up further in an interview with former DG COMP staff:

All the lobbying ended up being very counterproductive. Almunia got very angry about all the attention and effort – this was not a battle that should be fought in the media. He did

not like that, and thought it was very American. And [NYSE-Euronext CEO) Niederauer misjudged the European institutions. They are much stronger here, I think, and harder to lobby – you can't lobby Congress over here. There is an institutional inertia, too, a way of doing things that is very hard to move from the outside. The cost you pay lobbying ends up being quite high.” (Anonymous Interview, Brussels, December 5, 2013)

In sum, it is clear that both publicly as well as informally, there was considerable political and private interest pressure on DG COMP. Despite this pressure, it is credible to suggest that DG COMP managed to cut an independent path and make this decision with a significant – if not absolute – degree of freedom from traditional sources of political influence. This claim is based on two broad sets of observations: first, like in other cases where lobbying was visible, both the national and private interest groups involved pushed and pulled in different directions simultaneously (and in the case of Germany as well as DB, appeared to change approach halfway through). This makes it difficult to claim with any precision that ‘lobbying’ by some group drove DG COMP’s decision, as it would require understanding why certain groups’ views held more purchase than others – an explanation that would ultimately depend on the arbitrating judgement of officials likely to be considering their own views on the merger. Second, and relatedly, the outcome does not align what we might expect given the relative power and resources of the parties marshalling for or against the merger. In short, why were the EU banks and the Franco-German merging parties unable to ‘outgun’ NASDAQ and the London Stock Exchange on this deal, especially with the support or at least non-opposition of Germany of France? In the end, the merger was blocked in a manner that reflected the preferences of some significant stakeholders and appeared to contradict, at a surface level at least, the preferences of other important financial market stakeholders. This suggests that DG COMP had an opportunity

in this merger to engage in a technocratic balancing of views, an inference that must be balanced against the caveats noted in this discussion, but that is also corroborated by the technocratic nature of the final analysis it submitted.

### **The impact on the broader EU agenda: a cost-based problem**

The finding that DG COMP was not strictly compelled to follow the preferences of states or firms (i.e., traditional sources of political interference) in this case does not mean that DG COMP was insulated fully from political considerations of a different sort – that is, intra-bureaucratic politics within the EC, whereby different policy programs and priorities can become relevant in the context of individual market structure decisions made by the competition authority. Indeed, broader policy considerations are very much salient in many market structure decisions, in particular considerations about what the Commission is trying to accomplish in various European product markets more broadly, including, at the highest level, its European market integration agenda. DG COMP has been and continues to be aware of this twin set of considerations: for example, in a recent speech, current Competition Commissioner Margrethe Vestager stated that “When we at the Commission reflect on which competition cases to prioritise, we also consider where our action would have a multiplier effect with wider political priorities” (European Commission, 2015).

Thatcher has investigated the recent pattern of EU-level merger decisions to consider this very balancing act, between advancing two liberal agendas that in many instances do not neatly fit together: pursuing further European integration at the level of the cross-border business firm, while also maintaining a level playing field and promoting competition. His findings are that the

Commission uses a combination of its potential veto via merger review, and its ability to impose conditions on merging parties, to achieve both aims simultaneously. As he puts it,

The Commission has been able to both approve [mergers] and also use the conditions to further open national markets to competition, thereby complementing Commission policies of ending national monopolies, and offering opportunities for overseas entry and hence greater European integration. (Thatcher, 2014, p. 16)

The corollary of this finding is that where this balance is not achievable, the Commission is less given to merger approval. Where there is a conflict between the goals of market integration (creating a large EU firm to complement efforts at breaking down national barriers, as was discussed in the chapter on Euronext) and product market competition (avoiding antitrust scenarios), and where DG COMP's efforts at achieving remedies from the merging parties fall short, it would be difficult for the EC to approve a merger. This does not mean, of course, that DG COMP is actively pursuing the Commission's broader regulatory agenda. However, it does suggest strongly that its market structure decisions are not made in a vacuum, and that these broader, intra-EC considerations about what the Commission is otherwise pursuing in the European single market – and how it is pursuing it – can become highly salient in the context of any given merger case.

Indeed, this is consistent with the outcome observed in the DB-NYSE-Euronext merger proposal, where the Commission was not convinced the merger would not materially harm its broader policy goals while also producing a desirable market structure from a competition perspective. What the subsequent discussion demonstrates is that the merger would have, in fact, materially obstructed key policy goals simultaneously being considered as a component of the EC's post-financial crisis market rules reforms. It would have made specific elements of this

agenda harder to realize, and would have imposed greater bargaining and enforcement costs on EU policymakers that subsequently tried to implement them in the face of a larger and more powerful market entity that was seen as likely to be obstructionist.

The threatened policy goals were essentially twofold, and intimately interconnected: a) to encourage a greater move towards the use of exchange-traded derivatives instead of over-the-counter derivatives trades, which are enacted in a less transparent manner in the bilateral market; and b) to open up the market in post-trade services (particularly clearing) to greater competition on a European-wide scale.

The second, market-structure priority has been on the European policy agenda for better than a decade. In 2001, a group chaired by Alberto Giovanni published an EC-commissioned report on the European market structure in post-trade services, which identified several impediments to the use of existing clearing and settlement arrangements on a cross-border basis within the EU which, in its view, “represents an important limitation on exploiting the economic benefits of the Internal Market and the euro” (Giovannini Group, 2001, p. 20). Notably, the report identified the primary barriers to more efficient post-trade services as being regulatory rather than commercial in nature. As a result, the appropriate policy initiatives would see the rationalization of cross-border differences in the treatment of transaction taxation as well as bankruptcy and insolvency proceedings. The report did not advocate for the creation of a pan-European firm to consolidate market activity in this space, and the European Commission began to consider ways to simultaneously open up these cross-border markets as well as promote more competition within them.

The impact of exchange firm consolidation within Europe on clearing market structure was therefore evident as a running concern through the 2000s, as multiple exchange merger

proposals were mooted. An earlier tie-up between the LSE and DB, proposed in 2004, brought post-trading concerns to the fore (Jenkins, 2005). Among the chief concerns then was – and continues to be – the vertical integration of trading and clearing services in a single firm, whereby financial products traded on an exchange (for instance, DB’s Eurex exchange) may only be cleared by the same firm’s in-house central counterparty (in DB’s case, the Eurex CCP). In May 2006, DG COMP released a position paper after an investigation that called for greater competition in the markets for trading and post-trading, noting with particular reference to the vertical clearing model that “vertical integration may result in foreclosure at all levels of the value chain and therefore lead to welfare loss. Whilst there may also be efficiencies, so far the Commission has seen no convincing evidence to substantiate this” (European Commission, 2006). At this stage, nearly five years before the merger proposal, DB and the consolidation of clearing activity in its vertically integrated model was already in the Commission’s sights.

The first iteration of the pan-European capital markets legislation, MiFID, which entered into force in 2007, aimed to increase competition through reforms to market structure, but only focused on equities (stocks) trading, and did not meaningfully address derivatives market structure, leaving DB to maintain its vertical model for its derivatives business. However, this changed with the post-crisis package of financial market reforms, where this policy goal – market structure changes in clearing – become intertwined with a newer, crisis-driven goal to promote the greater use of trading venues and clearing for derivatives products.

The G20’s 2009 Pittsburgh declaration committed its members to several goals, two of which are particularly notable in the context of this case: a) the greater use of transparent trading platforms for derivatives that had previously been traded on a bilateral, opaque basis; and b) the increased use of central clearing services for derivatives that had previously not been subject to

those requirements (G20, 2009). These requirements were quickly identified as directly implicating existing market infrastructure firms, which already had clearing houses in place, and stood to benefit from the increased, regulation-driven use of their trading platforms. Writing in the Financial Times in late 2010, as these reforms were beginning to take shape, one journalist helpfully identified the policy implications as follows:

The prospect of clearing houses having to handle far more business – and thus risks – than before turns them from being mundane parts of the market structure into systematically critical institutions . . . Yet at the same time regulators are keen to see market participants have choice as to where to put their trades for clearing, to keep fees as low as possible and encourage innovation. (Grant, 2010)

The result was that an existing imperative – to open up post-trading to competition – became even more important given the new push to force market participants to use trading and post-trading infrastructures to a greater degree in order to enhance market stability and transparency. One of the more politically controversial elements of the recast MiFID legislation (which was subsequently re-opened and overhauled to address the fallout from the financial crisis) was therefore the proposed expansion of market structure reforms to the previously-untouched derivatives markets. The scope of the proposed changes ultimately included DB's silo model.

It is important to understand that these regulatory reforms were being negotiated at the highest level at the same time the DB-NYSE-Euronext merger was announced (while the legislation was finalized in 2014, specific rules are not yet in place and implementation is not expected until 2018). It was not certain where the rules would come out at the time of the merger announcement, but it was understood that market structure reform to clearing was going

to be included in the package. In fact, the final text of the regulation accompanying MiFID II (called MiFIR), which was agreed nearly two years later, includes articles dealing with ‘open access’ to clearing houses, which aim to break down the vertical silo and force incumbent clearing houses to accept new products for clearing, and to allow other clearing houses to clear their products as well. While not yet implemented, this would prove an important market structure change. What is important here is that these changes were high on the political agenda in DG MARKT at the time. Indeed, DG MARKT was drafting the first version of the recast markets rules at this juncture.

Given this high-level policy initiative, what were the implications for the merger review? How did this play out in the context of DB-NYSE-Euronext? In short, the proposed merger fell afoul of what the European authorities were otherwise trying to accomplish in the derivatives markets. It represented a significant impediment to their regulatory agenda.

In the technical details relating to the merger review, two key implications of the proposal weigh heavily in this discussion (European Commission, 2012b). First, the merged firm would have controlled in excess of 90% of the market for Euro-denominated interest rate derivatives that are traded on exchange, which are among the most popular and most widely traded financial instruments in the world. There was simply no competitor inside or outside of Europe offering similar scope in these Euro-denominated products, in terms of liquidity or open interest, key measures of a product’s attractiveness to the market. Given the push to increase the use of exchange-traded derivatives of this sort, the monopolistic position of the merged firm in a key product market that was being targeted for greater use was a key concern.

Second, the fact that DB operated a vertical silo came back to haunt the merging parties – as it was described in the Financial Times, the “Deutsche boerse/NYSE deal involves combining

not only two big derivative exchanges but also clearing houses, currently the centre of heated discussion in Europe over competition and access to post-trade structures” (Grant and Tait, 2011). DG COMP could not know, at this time, what the ultimate impact of the market structure reforms underway in Europe would be, but it is reasonable to infer that the prospect of moving more derivatives traffic into a vertically-integrated firm and then struggling even more to subsequently break up that silo would have been deeply unattractive. This is borne out by DG COMP’s list of remedies that it required from the firms, which identified the need to move away from the vertical model as a fundamental remedy that the authority would insist upon. While the counterparties to the merger made concessions, they were insufficient to placate DG COMP because they were limited in scope to new products, not the existing products (like the interest rate derivatives just discussed) that were already in high demand and were set to increase in volume and use (Grant and Barker, 2011). On the impact of the merger, Commissioner Almunia was unequivocal:

The merger between Deutsche Börse and NYSE Euronext would have led to a near-monopoly in European financial derivatives worldwide. These markets are at the heart of the financial system and it is crucial for the whole European economy that they remain competitive. We tried to find a solution, but the remedies offered fell far short of resolving the concerns. (European Commission, 2012c)

It is curious to note that divisions emerged within the European Commission over its approach to this merger proposal, and it is critical evidence in support of the theory that these divisions erupted not over the strict market structure impacts of the proposal, but rather its impact on the European Commission’s broader policymaking efforts: in short, both proponents and opponents of the merged framed it in the context of the Commission’s contemporary

rulemaking agenda. The French Commissioner for the Internal Market, Michel Barnier, publicly broke ranks with Almunia about the value of a “European champion” in the industry (Barker, 2012b). Barnier stated instead that he wanted to promote a merged entity as a ‘European champion’ and counterweight to what he perceived as American dominance in the global derivatives market. There are two potential explanations for this deviation on Barnier’s part, and both are, in fact, consistent with the broader explanation being offered here.

First, it is possible that Barnier was simply swayed by and pursuing a different set of political priorities, seeing the merger through the lens of an industrial policy logic rather than in the context of the Commission’s broader political priorities. In this sense, he was responding to a more populist set of political imperatives whose supporters, as was demonstrated above, did not gain purchase over the ultimate decision-making and were overridden by more technocratic policy concerns. An employee of one of the merging firms put it bluntly: “We’ve never been allowed to create the kind of market champion in Europe that can actually create a global marketplace - it’s impossible to create a big player. We think it’s a great idea. Barnier tried to support it and us but he did not succeed.” (Anonymous Interview, Brussels, May 28, 2013)

Second, it is certainly plausible that Barnier was pursuing a different means to the same end – that is, he saw the merger as inherently complementary to the agenda being pursued in the post-crisis period. This interpretation of Barnier’s motives was considered in Brussels and in the press as he publicly distanced himself from Almunia’s position, with one journalist noting the possibility that

[Barnier] sees the creation of a mega European exchange, carrying with it the reassuring labels of “transparency” and “fully regulated”, as the perfect antidote to the “opaque” and “unregulated” OTC markets. We know Mr Barnier’s views on the OTC markets from his

statements on Mifid II (the Markets in Financial Instruments Directive), whose thrust is to shift as much OTC trading on to exchanges and other formal platforms as possible (Grant, 2012).

This was not necessarily an unpopular view in Europe at the time. One academic analyst came to a similar conclusion in a paper on the proposed merger, arguing that “from a political economy perspective, the merged entity establishes a market-side prerequisite for further regulatory harmonization in the European financial markets; and can give further impetus to aligning regulatory interests of competitiveness and stability across the Atlantic” (Enderlein, 2011, pp. 20-21). In this sense, the merger would produce not only a corporate champion for Europe, but a market-side partner that would advance Europe’s regulatory agenda on an equal footing in transatlantic regulatory dialogues (cf. Posner, 2009).

In an additional and fascinating detail, this regulatory-partner analogy was the argument advanced by DB and NYSE-Euronext themselves – in fact, it was a major component of their broader public relations strategy. In a letter to the President of the European Commission (i.e., above the heads of both Barnier and Almunia), the counterparties argued explicitly that their merger would be helpful for advancing Europe’s regulatory goals. The letter is worth quoting at some length:

The Transaction will also advance the European Union’s regulatory agenda, at a time when the European Union is striving to achieve globally consistent and transparent regulations with its partners in the G20 while some jurisdictions continue to favour a “light touch” approach. Approving our combination would create a transparent and regulated transatlantic marketplace with a strong European core that would function as a global standard setter and help to contain regulatory arbitrage. By contributing to greater

transparency in trading and clearing financial instruments, the Transaction will facilitate the effective implementation of European Union financial services regulation and offer a unique opportunity to deepen regulatory cooperation and reduce the risk of regulatory arbitrage.

However, if this combination is prohibited by the College of Commissioners, the global consolidation of exchanges might very well shift the balance towards countries favouring “light touch” regulation, which would severely endanger the European Commission’s agenda. By contrast, approving the proposed combination of Deutsche Börse and NYSE Euronext would significantly increase the likelihood that the European Union’s regulatory philosophy would become the global standard, thereby helping to achieve the European Union’s goal of establishing strong, transparent, and regulated financial marketplaces. Accordingly, we would like to express our personal firm commitment to continue to support the Commission in its endeavour to establish and enforce internationally harmonised regulatory standards for the world’s financial markets. (Niederauer and Francioni, 2012)

The claims made in this letter are notable because they strongly and obviously reflect the theoretical view that is being advanced in this dissertation, notably that mergers are considered through the prism of the broader regulatory agenda, particularly the implications of this merger for Europe’s policy goals. That does not mean, clearly, that the arguments were effective. Indeed, they proved ineffective, and Barnier was ultimately isolated on this point, because the broader impact of the merger was so squarely off-side with the goals being pursued by the Commission. In this sense, the focus on the regulatory agenda in both the letter and in Barnier’s intervention is not unimportant, but the claims that these parties advanced were simply not

empirically credible. The merger would have been costly for the Commission's broader reform agenda, and key decision-makers (Barnier aside) appeared to accept this. Indeed, the parties themselves understood the broader implications of their merger, and as a result engaged not only with DG COMP but with DG MARKT as well, in order to make assurances – ultimately unsuccessfully – that they would not stand in the way of the Commission's ongoing efforts. As a DG MARKT official relates it,

There was an obvious link to the financial regulatory agenda... so it was not strange that the parties also spoke to DG Markt. [But] it was very unusual that the parties would approach someone other than DG COMP in the context of a merger. There are many issues that, yes, stakeholders come to see us both, whether it's on regulation or something else. Because we both have a stake in many of the market issues. But this is rare, for merging parties to visit DG MARKT and reach out to me, personally. In 10 years I've never seen this before. (Anonymous Interview, Brussels, December 5, 2013)

So, while the firms were clearly concerned about their perception within DG MARKT because of the impacts their merging would have on the MARKT agenda, their lobbying efforts within MARKT did not gain traction at the staff level. Another DG MARKT official addressed the divisions at the political level that emerged between Barnier and Almunia and countered that these divisions did not extend to the staff level at DG MARKT, where the individuals engaged in reforms (and, in fact, heavily comprised of competition lawyers) generally saw eye to eye on most issues with their DG COMP counterparts, agreeing that the merger threatened what was being pursued more broadly, and that the merged firm would present a severe obstacle to those efforts : “So MARKT and COMP were not entirely contradictory as a result...In fact, it is

entirely contradicting to build a single, foreclosed open interest marketplace.” (Anonymous Interview, Brussels, June 10, 2013)

This view – that the merger would ‘foreclose’ on policy questions being mooted at the highest level – was advanced, again, by a separate DG MARKT official:

What the Commissioner [Barnier] was concerned about, from a political standpoint, was a simple political point. That we should not have everything move to the US, and not have these operations happening in Europe. But there were also specific regulatory points - on EMIR [a separate regulatory package pushing trades onto exchanges] and MiFID [advancing open access]. The concern was that the merger might end up pre-empting decisions that not been made yet - the decision on the merger might make those decisions. ie, for DG COMP and for us - this is what the environment is going to look like. Does the decision make as much sense in that context, once decisions have been made?

(Anonymous Interview, Brussels, May 27, 2013)

One observer noted that the merging parties knew they were offside with the anticipated regulatory push in Europe, but for economic reasons could not adopt the required remedies, because doing so would have undermined the rationale for the merger: they couldn’t agree to DG COMP’s counterproposals because they couldn’t, for economic reasons, commit to commercial undertakings that would have cost them rather than made them money. In that observer’s words,

Because the regulatory objective was to open up trading in derivatives the way it is in equities. Although there are important questions around who actually owns the open interest, etc., that was the plan. So this would be a world in which EU derivatives exchanges are subject to open access and competition where in the US they are not. This

would have subjected [the firms] to a very different operating environment. (Anonymous Interview, Brussels, May 27, 2013)

Finally, an individual closely connected to the deal noted that

It was clear that through MiFID, EMIR, greater volumes of derivatives were going to be traded on exchanges. The shift from [over-the-counter] to the exchange environment would enlarge the scope of contracts for which Liffe [owned by NYSE-Euronext] and Eurex [owned by DB] would compete. It was good that the volume was coming, and it was good not to let them merge...The perceived benefits of bringing OTC onto exchanges would have been less by having it consolidated, by having it on a single marketplace. That was the EC's vision. And the Commission would deem that this was consistent with its broader objectives. The consolidation agenda lost. (Anonymous Interview, Brussels, May 28, 2013)

In sum, the logic, and the foreseeable consequences of the merger proposal did not coincide with the regulatory agenda underway in Europe at the time, something confirmed by multiple individuals involved in the proposed transaction and its review. The merger presented both present and, importantly, future bargaining and enforcement costs to the authorities pursuing the reform agenda, who would have had an even larger vertical silo to disrupt, and an even more politically and economically powerful firm with which to engage on that issue and other, ongoing issues. It is important, of course, not to overstate the causal impact of this disjuncture between the merger and broader policy goals. DG COMP's decision – as was repeatedly emphasized in meetings with its officials – was based on the market structure implications of the proposal, and this logic is evident in its 447 page report (Anonymous Interview, Brussels, June 10, 2013). The merger failed on antitrust grounds and was blocked as

a result. What is crucial – and what demonstrates clear consistency with the logic of the theory of regulator dependence – is that these very market structure concerns were driven by previous policy decisions not to break up the vertical silos that dominated exchange-traded derivatives trading and clearing in Europe. Moreover, the ongoing market structure effect of that historical policy (non) choice meant that market structure reform was itself a regulatory agenda item shared across the EC institutions most intimately connected with shaping Europe’s capital markets, namely the competition authority and MARKT, the entity that ultimately drafted the rules. Moreover, it is important to recognize that DG COMP and MARKT staff were in contact on this proposal and, as noted above, aligned at a staff level on the appropriate course of action. Indeed, when pushed on this point – the impact of the merger on DG MARKT’s reform efforts – a DG COMP official conceded that “that was a question we asked inside the institution. Will it help the agenda or not?” (Anonymous Interview, Brussels, June 10, 2013).

### **Sources and measures of dependence: market structure and EU authority**

The crucially important policy developments – or non-developments – that generated dependence on these particular firms for the purposes of this merger decision have already been identified in the preceding discussion.

The first and ultimately critical decision was with regards to market structure at the European level, primarily the antecedent lack of market structure reforms in the derivatives markets in the first MiFID legislation. Pure market structure reforms in that directive were limited to equity markets, and primarily – and in a manner that mirrored the changes undertaken by the US SEC in its ‘Regulation NMS’, discussed previously – consisted of provisions to introduce competition into stock trading in order to reduce fees and increase efficiency under the

banner of ‘best execution.’ As noted in the previous chapter, these reforms were substantial and led to equity market fragmentation in both the US and EU, but were crucially not extended to either the derivatives markets or the post-trading (clearing and settlement) space. Those were the crucial product markets in this merger episode, and the consolidation that DB would have been able to undertake under its vertical silo model proved to be the determining factor in the merger. That is not to say that the first MiFID did not have an impact on the derivatives markets, which it did, primarily by introducing certain new obligations and requirements regarding how over-the-counter markets were run, particularly in the secondary markets for equities and bonds. But the fundamental structure of the European listed derivatives market and the provision of post-trading services was fundamentally untouched, including the vertical silo model in trading and clearing. This became a source of dependency for the European Commission as it moved, in the post-financial crisis period, to implement changes to the way derivatives trades are executed.

In particular, the result of this historical policy trajectory was that at the time of the merger DB’s Eurex was one of the largest derivatives marketplaces in Europe and its central counterparty (CCP) one of the most liquid destinations for derivatives clearing, particularly financial futures. As the Commission moved to promote the greater use of central clearing of over-the-counter (i.e., not exchange-traded) derivatives, it looked to DB-Eurex to enter this market space and provide this service, particularly to counterbalance the dominance of London-based Swapclear in over-the-counter interest rate derivatives. Eurex did indeed enter this market at nearly the same time as the merger proposal – a countervailing market structure option that the Commission was depending on, and was helpful from their rule-making perspective. This was also a source of regulatory dependency in the context of the Eurozone’s “location policy”, under

which derivatives denominated in the Euro were only to be cleared at CCPs physically located in the Eurozone – a requirement that Eurex met (and that as a source of dependence was functionally nearly equivalent to the Bank of Canada’s mooted the need for a “made in Canada” solution to the new G20 clearing mandates). Moreover, further rules that would make it more expensive to trade derivatives that were not cleared or exchange-traded promised to incentivize the greater use of futures like those listed on Eurex, for which, again, the DB subsidiary provided a venue that the Commission was counting on as it developed new mandates and standards.

As a result of these dependencies, the European Commission’s DG MARKT took the view that it was desirable to avoid a merger that would complicate its policymaking efforts. The Commission found itself needing DB to help it meet its policy objectives without simultaneously creating a monopoly that would make it harder and more expensive for market participants to access exchange-traded derivatives and clearing services – i.e., without a cross-border merger that would make it more challenging for the Commission to implement the regulatory and structural changes it sought in the exchange traded derivatives market.

DG MARKT’s opposition to the merger was also, of course, so that the Commission could subsequently achieve what had been a long-standing policy goal, one that had simply not been tackled at the time of the merger proposal: introducing more competition into the derivatives market space. This was indeed noted by a Commission official, who stated that “Mifid I opened up equities to competition, and MiFID II is a step further – and open access for CCPs is being introduced” (Anonymous Interview, Brussels, June 10, 2013). A separate Commission official expressed greater uncertainty in identifying the same, forward-looking dynamic given the existing policy terrain: “We are not even sure now where MiFID II is going. Is it opening up clearing? There is resistance to this in Parliament, particularly from German

MEPs. Even now it isn't clear it will open up this market" (Anonymous Interview, Brussels, June 10, 2013). The key here, of course, is that the market structure changes were not yet agreed or finalized vis-à-vis clearing and trading in derivatives at the time of the merger, something that was evidently understood by officials scrutinizing the deal.

The second critical decision related to the allocation of authority over a) the development of markets rules and b) European merger review to the European Commission. As stated at the outset of this chapter, considerable power over the development of European capital markets rules and the structure of the market have now been scaled up to the regional level, and EU institutions – including the European Securities Markets Authority – are responsible for legislation and rule development, and in limited ways they are involved in rule enforcement and compliance as well (although they mostly lack punitive sanctioning tools). It is highly plausible that if these prerogatives had remained at the level of individual Member States, a very different type of political dynamic would have emerged. First, the German government was unlikely to ever seek to undercut its “corporate champion” in the exchange industry, and in many ways the focal point for Frankfurt’s financial service industry (and indeed, German Members of the European Parliament in particular have worked to water down provisions relating to open access that would be harmful to the vertical silo model in recent years, as noted in the preceding paragraph). Second, had another Commission institution (MARKT) not been simultaneously developing a reform agenda that became a key consideration for those contemplating the merger, different dimensions of the merger – its benefits for European integration in trading and post-trade, for instance – may well have become more politically salient. This counterfactual is not knowable, but it is evident that the fact that both merger review and capital markets rulemaking had become European Commission competencies removed the merger and its implications from

Member States' direct purview – and political calculus – and subjected the deal to the Commission's alternative set of technocratic and harmonizing concerns as a result.

Finally, it is important to consider that the merger decision issued by DG COMP was, in fact, precisely the type of historical policymaking outcome that has been theorized here to lead to regulatory dependency. What is more, in the previous two chapters historical market structure decisions have been identified as critical in giving rise to fully-integrated and dominant market infrastructure firms upon which regulators are subsequently dependent, particularly in Canada and Australia.

In this vein, it is valuable to subject this decision-point – as an explicit example of a market structure decision point – to an additional and more nuanced test: not simply whether historical policy choices can be identified that gave rise to dependence and thus informed this particular merger decision, but also whether this particular decision was made with consideration given to the potential future dependence. In previous empirical chapters, policymakers have evinced forward-looking considerations in response to certain merger proposals, in order to reduce their dependency going forward. This has suggested strongly that dependent regulators become aware of their dependencies during merger episodes and seek to mitigate them going forward, so that they may not need to interfere in the market for corporate control so bluntly in the future. A related question of relevance in this chapter, then, is whether policymakers, when faced with a decision-point that could have eroded their bargaining power and cost them key concessions on important policy goals, *consider* those costs and make decisions to avoid such future conditions of dependence. In short, did the logic of dependence enter policymakers' minds at this juncture, as an outcome to be avoided (or perhaps, for some, embraced)?

It is worth recalling that the merging firms themselves argued for something akin to dependence in making the case for the merger, particularly the manner in which they portrayed their increased weight and market power as something that Europe would need if it hoped to effectively enact its policy preferences in the global derivatives markets. Following this logic, the firms tacitly argued that without a substantial market-side partner Europe's policy agenda would be only partly or ineffectually implemented. Commissioner Barnier at DG MARKT appeared to have been convinced, but others were not. Could the residual concerns of some officials about the implications of the merger have been driven by the desire to avoid a future scenario in which they needed the merged firm to cooperate in order to accomplish their goals? Did anybody see dependence as a source of concern?

In fact, precisely this consideration was voiced by a Commission official involved in markets regulation: "You think, if already, now they are able to bully us around like this – how will we regulate them, getting them to stick to their commitments on things like how to get [open] access? We would spend years in court, like on Microsoft" (Anonymous Interview, Brussels, June 10, 2013). This comment was made in the context of a discussion about the firms' lobbying, suggesting that not only was the lobbying counterproductive, for at least some officials it presaged difficulties down the road – particularly the expenditure of considerable effort confronting a dominant market player – that they did not want to face given their broader efforts in the markets. The official continued on to link the success of the future policy agenda at least partially to the size and power of the firms that will be regulated: "In what is coming, the balance, struggle and political action will all be over this: transparency and access in the market. In Europe – how will this effort fall apart, and where will the pressure...come from?"; this same official also noted that "the conclusion was that a huge monopoly with huge open interest wasn't

what we wanted” and noted both “the prudential implications” and, crucially, “the monitoring implications” as reasons why that was the case (Anonymous Interview, Brussels, June 10, 2013).

It seems from these concerns that the Commission did not want to deal with a monopoly going forward because of its likely impact on its capacity to enact changes swiftly and effectively, and ensure they were adopted. External observers close to the deal offered similar observations about the implications of becoming dependent on the firm on a forward basis if the merger had been allowed, with one arguing that to do so would have meant reduced bargaining power for regulators and increased monitoring costs as it operated on a cross-border basis – in both instances, concerns that are predicted by the theory: “On the behavioural side - they were going to be asked not to increase prices for three years. This may have never been offered as a formal remedy, I don't know. ...Plus it is very difficult to monitor” (Anonymous Interview, Brussels, May 28, 2013).

Another person close to the deal augured simply and similarly that the merger led to worries that it would leave Europe and its market authorities with a sole infrastructure option, because “[the impending European Markets Infrastructure Regulation] in particular would reinforce that monopoly they were building. How? You could not go to [over-the-counter] anymore – you have to trade on exchange *and there is only one significant player left*” (Anonymous Interview, Brussels, June 18, 2013; emphasis added).

### **Conclusion**

This case was a hard test for the theory, insofar as it was a decision rendered by a competition authority rather than a regulator, subject to significant and vocal lobbying, and a market structure decision point that is theorized in this dissertation to lead to dependency. The

standard of evidence on each front was therefore considerable, and the case does not align as neatly with the theory's predicted process observations as the cases previously discussed. Not only was there considerable uncertainty about how the final regulatory agenda would take shape, but there was also formidable lobbying and potential influence from certain Member States as well as notably absent lobbying from others that may, in fact, have been causally significant; moreover, the decision itself was fundamentally a market structure determination rather than a veto exercised directly by a market authority.

How do competing explanations fare in this case? Despite the shortcomings of the theory of regulator dependence in this case relative to previous chapters, it still provides more leverage in the aggregate than other explanations:

- While lobbying is certainly present in this case – from both Member States as well as organized financial service interests – it is very difficult to infer definitively that it led to the observed outcome of a blocked merger. There is evidence to suggest that certain elements of the financial service industry demanded key remedies to enable the merger to go through, and to the extent that they were not offered by the merging counterparties, this was a key dynamic; in addition, the UK appears to have been lined up against the merger, although its opposition was in contrast to the neutrality and possible support of the French and Germans. The counterfactual claim – that a strong German effort to back the merger would have resulted in its going through – ignores the power of the UK to oppose Germany effectively in EU institutions and would, as is theorized in the dissertation, have even led to the possible opening of an insulated space for the Commission, protected by arguments on both sides of the ledger and empowered to undertake technocratic analysis as a result. In short, neither the empirical record nor the

counterfactual points clearly to a victory for Member State or business lobbying – but their influence must be considered, and was indeed considered in this chapter.

- The institutional argument is not fully tested because the case is deliberately aimed at the supranational, EU level rather than at the level of individual jurisdictions and Member States. However, to the extent that the French appeared – again – to be either neutral about or even somewhat supportive of the merger (via Commissioner Barnier), they do not conform to the dominant typological prediction offered by the Varieties of Capitalism approach. Moreover, as a coordinated market economy, the Germans might have been expected to be highly reticent to accept any changes that would impede existing insider-based mechanisms of economic and commercial planning, particularly in the clear financial capital of Germany, Frankfurt. But as the case study suggested – if not in great detail – the German approach was largely ambivalent and notably silent, which is explainable with reference to the broader political context, but difficult to explain through a VOC lens.
- Finally, to the extent the US and EU compete with one another for both market flows as well as regulatory power (Drezner, 2007; Posner, 2009b) it could have been expected that the European Commission would have been strongly minded to support the merger as a counterweight to American power in both the regulation and provision of listed derivatives and central clearing services, especially in the post-crisis period. Indeed, this was the line taken by Commissioner Barnier, with the rhetorical support of the merging firms. However, it ultimately failed and the opposite outcome was delivered by the Commission. It is not clear that mercantilist competition between the US and EU was a

strong factor in shaping the outcome here, despite its prevalence in both policy circles as well as the financial press at the time.

Table 7

*Summary of observations relating to DB-NYSE-Euronext*

<b>Jurisdiction</b>	<b>O1: Regulators’ insulation</b>	<b>O2: Regulators’ concerns about costs</b>	<b>O3: Regulators’ response</b>	<b>O4: Regulators’ dependence</b>
Europe	Medium – reasonable to infer substantial insulation, but impossible to reject counterfactual	High – ongoing regulatory agenda threatened, particularly post-crisis derivatives reforms	Negative-blocked	High – due to previous failure to introduce competition in central clearing, and creation of EU level authorities for markets policymaking and EU internal market structure; moreover, some officials recognized that dependence would possibly increase if merger allowed to go through)

Table 7 summarizes the degree to which the theory of regulator dependence better explains the failure of this merger and the underlying causal sequences leading to its being blocked by the European Commission. As the table shows, on balance, the fundamental logic of

the theory has significant purchase in this case, especially when compared to the shortcomings of the other approaches just discussed. Not only is there reason to believe that the decision was significantly – if not absolutely – insulated from political pressures, there is also considerable evidence that the costs of the merger were weighed in the context of what rule makers were attempting to accomplish in the European capital markets. It is important here to re-state that this case was selected precisely because it pushes against the scope conditions of the theory, not least O1, requiring a high degree of regulatory insulation. While that insulation is less certain in this case than in others, it remains reasonable to claim a meaningful degree of insulation, and the positive finding relating to the subsequent scope condition (O2), i.e., the observation of regulators' concerns about costs, is a positive confirmation that the theory's causal logic ought to apply – which it indeed does, as measured against hypotheses O3 and O4. In this sense it was highly significant that previous developments in both the structure of the market and the nature of EU policymaking had left the Commission practically dependent on one of the merging firms – DB – to provide infrastructure that clients could access in a cost-effective manner in order for Europe to meet its G20 commitments, as well as a dependency on the firm to achieve the EU-level policy goal of increasing competition in the derivatives exchange industry. It is further confirmation of the theory that the decision to block the merger was directly related to these antecedent conditions.

Moreover, there is persuasive evidence not only that previous policy developments regarding market structure and the allocation of authority had an impact on the decision as just described, but also – importantly – that stakeholders were *forward-looking* about the impact of the merger outcome on the subsequent development of a relationship that could be described as a dependent one. In the estimation of those stakeholders, dependency was not likely to be helpful

for the forward realization of key policy goals. Each of these findings is valuable confirmation of the basic logic of the theory of regulatory dependence. In sum, then, the theory has ample explanatory power over this, its most difficult test, and the one that was most likely to disrupt its key predictions. While the caveats presented here are necessary and reasonable, they do not appear to override the general predictive value of the theory in this episode.

## **CHAPTER VIII:**

### **ASSESSING IMPLICATIONS AND PROBING FUTURE RESEARCH**

#### **Introduction**

This dissertation has developed and demonstrated the explanatory power of a theory of financial regulator dependence, a theory that explains when and why cross-border integration proposals by private exchange firms will be blocked by regulatory authorities. The theory is premised on the independent preferences of regulators – i.e., preferences that are not accounted for by reference to the lobbying activities of businesses or the electorally-oriented attitudes expressed by politicians. These independent, *sui generis* preferences are not, however, based purely on regulators' policy-seeking motivations, but rather they are shaped by the institutional context in which regulators and the firms that they oversee operate. In certain situations, regulators come to be dependent on large and even dominant financial service firms – particularly commercial and regulatory undertakings at the firm level – in order to execute and deliver key policy initiatives that they are working on, and do so in a cost-effective manner. Where this is the case, the dissertation has shown that regulators will prefer strongly that those firms do not merge on a cross-border basis as doing so is likely to reduce their leverage, control, and oversight over the firm, not least by making it costlier to ensure that the firm pursues certain undertakings (and avoids others). Regulator dependence leads regulators to intervene in merger proposals, blocking them where they can.

The institutional contexts that give rise to dependence are themselves shaped by historical policy processes that shape the allocation of regulatory authority over the exchange market, and the structure of the market itself. The outcomes of these historical processes can give rise to

dependence by increasing the number of regulatory bodies that have a stake in how the firm is regulated, either as a result of vertical integration at the firm level that brings different business activities together in the same firm, or by giving rise to a decentralized regulatory structure; by giving the firm a direct role in setting and implementing rules with an impact on the market; and by concentrating market activity in a single firm with a dominant market position. These additive determinants of dependence pose dilemmas for regulators by creating conditions in which their job performance is tied to undertakings at the firm level. This directly ties regulators' preferences regarding international firm-level market integration to previous policy outputs about the shape and oversight of the domestic market.

The primary findings of the dissertation are twofold: first, that a critical determinant of an attempted merger is the preferences of the public officials charged with overseeing the relevant firms, rather than the preferences of either organized (private) or diffuse (voting) groups; and second, that those preferences are based on the relationship that regulators have with the relevant merging firms – in particular, whether or not regulatory authorities are in a position of dependence on private entities, a relationship that leads them to strongly prefer certainty about the degree of compliance and cooperation they can expect from the firms they oversee. This certainty is best realized through a domestically-contained (i.e., locally managed and operated) firm, with the result that dependent regulators block mergers. Ultimately, this dynamic is rooted in historical policy choices with institutional impacts, namely decisions about the structure of regulatory authority and the structure of the exchange market. The dissertation thus contributes – and adds nuance – to existing historical institutionalist approaches in political economy that look at global regulatory outcomes by reference to domestic institutional decision-making, and

makes it clear that regulators' own preferences are often important and even determinative with regards to particular discrete cross-border market integration proposals.

### **Summary of the dissertation's findings**

To arrive at these two overarching findings, the dissertation has proceeded across three empirical chapters and analysed three cross-border merger proposals in detail, while considering whether the dynamics that were observed in four additional merger proposals are also consistent with the theoretical arguments developed in the dissertation. In doing so it has subjected the theory to different types of tests: in Chapter 4, a straightforward test of the impacts of static conditions of dependence in two discrete merger proposals; in Chapter 5, a dynamic test of the impacts of changing conditions of dependence over three merger proposals involving the same firm; and in Chapter 6, a series of hard tests for the logic of theory where the process evidence is not unambiguously supportive of its predictions.

Chapter 4 analyzed the Canadian-British merger proposal between Toronto-based TMX and the London Stock Exchange. It identified the impact of dependence on that merger proposal by demonstrating the reaction to the merger across two jurisdictions where the degree of dependence was different, and static: the case thus demonstrated that the predictions generated by the theory were consistent with observed outcomes. In Canada, historical policy developments regarding the structure of the exchange market had concentrated services in a single firm and given that firm a high degree of self-regulatory power over the markets it ran – the converse was true in the UK. Interviews with Canadian stakeholders repeatedly confirmed that the predicted cost-based mechanism for regulators' concerns was a primary motivation for

their behind-the-scenes activity to interfere with the merger and coordinate an alternative outcome.

Notably, while there was private interest group lobbying in Canada it was split in terms of the valence of the business interests that were observable, a pattern that is repeated in several of the other cases analysed here, and a phenomenon that gives regulators a relative degree of insulation to pursue their own desired outcomes. Similarly, the Canadian case does not feature conclusive action by electorally-motivated office-holders, a pattern that is again observed in the subsequent cases, with the same effect. In a brief discussion of the proposed merger between Australia's ASX and Singapore's SGX, the Australian government's decision to block the merger was also found to be explicitly – and publicly – tied to its impact on Australian authorities' ability to pursue desired policy goals. The goals that Australian regulators were dependent on ASX to realize were particularly but not exclusively the efforts they were undertaking to reform and oversee the cleared market, a dependence that emerged as direct result of previous market structure developments.

The subsequent two chapters moved beyond analysis of cases with static conditions of dependency across two jurisdictions, and subjected the theory to more rigorous tests.

Chapter 5, on the various mergers involving the pan-European exchange firm, Euronext, identified the effects of changing levels of dependence. The primary case in that chapter, the 2007 transatlantic merger between NYSE and Euronext, went through (despite the protestations of certain actors in France) because the conditions of dependence were absent on both sides of the Atlantic – both existing allocations of regulatory authority and equities market structures lowered the absolute level of regulator dependence. Previous decisions on these issues in the US had a similar effect on regulators there as the US SEC did not have objections to the transatlantic

merger. Even though regulators were concerned about their autonomy and power in these cases, they chose to address those concerns through innovative policy tools that fell short of blocking the merger, including at the level of the merging firms' bylaws: these innovations were not available to regulators in positions of dependence in Canada and Australia. An analysis of another transatlantic merger from this period, NASDAQ-OMX, displays similar characteristics, albeit with fewer policy innovations at the back end, i.e., as a condition of approving the deal.

Notably, this chapter also elucidated the impacts of changing degrees of dependence. While conditions in Europe between the initial pan-European merger of the Amsterdam, Paris, and Brussels bourses and the subsequent tie-up with NYSE did not materially change, a decided shift took place in the post-financial crisis period: namely, that regulators in jurisdictions with historically bank-finance dominated systems of corporate funding became newly-dependent on alternative mechanisms of financing the market as banks withdrew under new regulatory capital pressures. This new level of dependence was reflected in the outcome of a third merger proposal involving Euronext: a further merger with a US firm (ICE) was approved on the condition that Euronext be spun off from the merged entity and returned to a strictly European-managed firm structure under the sole oversight of its European regulators – a condition of approval of the deal that was identified in interviews and public analyses to be directly tied to this new source of policy dependence on the exchanges. In this sense the merger was approved, but in a way that functionally blocked a further transatlantic tie-up involving the Euronext exchange and ensured that it would return to strictly European management to pursue particular, Europe-focused policy goals for the cash equity markets, which it has now done. This dynamic, changing level of dependence therefore has precisely the impacts anticipated by the theory, as increasing levels of

dependence led to increasing intervention in the market for corporate control of the Euronext exchange.

Finally, the dissertation's last empirical chapter provided a difficult test for the theory, in that the decision was presided over by a competition authority rather than market regulator; featured significant levels of private firm and EU Member State lobbying; and was itself a market structure decision that is, elsewhere in the theory, an antecedent independent variable rather than a discrete cross-border merger decision point. While the findings on the impact of lobbying are somewhat ambiguous, it is also the case that the key inferences in that chapter do, in fact, confirm the broad expectations of the theory, even in a hard test. Most significantly, the chapter demonstrates that the European Commission's market rule maker at the time – DG MARKT – had significant concerns about the impact of the merger in terms of the costs to its broader regulatory agenda: the provision of cost-effective infrastructure to buttress Europe's implementation of the post-crisis G20 mandates for the derivatives markets and to introduce choice into the cleared derivatives market – the latter a long-standing regulatory priority. Moreover, the necessary involvement of Euronext and DB in these policy goals and the Commission's resultant dependence on Euronext and DB (the latter in particular) to accomplish them was result of previous decisions, in particular failed efforts to introduce Europe-wide competition in the exchange traded derivatives space despite scaling authority for those rules up to the European level. Finally, interview data shows that the decision was viewed by at least some officials as a key inflection point that could have reduced their leverage going forward – that is, it was viewed by officials in the same manner that it has been theorized in this dissertation, as a policy-making juncture of a historical nature, and one that can lead to greater or lesser degrees of dependence going forward.

## **Beyond the theory: the implications of regulator dependence**

This dissertation has considered both empirical subject matter (the exchange industry) and political subjects (market regulators) who have only infrequently been scrutinized in political economy. Beyond this empirical contribution to the discipline, the dissertation has also made common cause with well-established historical institutionalist approaches to global economic phenomena, finding that convincing explanations for system-level outcomes can be found in the manner in which domestic political economies are constituted due to historical policymaking processes—ultimately, finding that domestic choices can have unintended consequences on the global stage (Krasner, 1977; Katzenstein, 1978; Moravscik, 1997; Bach and Newman, 2010a; Fioretos, 2010; Eberle and Lauter, 2011; Butte and Mattli, 2011; Farrell and Newman, 2014a, 2014b). This is an established conclusion, but this dissertation has moved beyond the traditional analytical approach that considers how institutions mediate societal preferences and project them into international, systemic politics. Instead, domestic institutional configurations are found to give rise to systematic variation in public sector officials' *own* preferences over international integration – a key finding.

Two additional contributions stand out for their potentially far-reaching implications. First, the dissertation has added depth and nuance to recent approaches that consider the relative insulation of policymakers from the forces that are often – if not typically – theorized to have causal impacts on their decisions, namely organized and diffuse social interest groups. These approaches, while limited in number, have demonstrated that where institutions limit popular pressure and where issues salience is low, state officials can enjoy a significant degree of autonomy in their approach to certain policy issues, which is a general approach that is shared by this dissertation (Culpepper, 2011; Ellermann, 2013). Importantly, this dissertation also shows

that in certain circumstances, salient policy decisions on which lobbying is observed may also be meaningfully considered insulated decision-points for regulators: what the theory of regulator dependence and subsequent case studies have also shown is that insulation need not be empirically absolute for it to be causally significant, a finding that opens new avenues for analytical and theoretical effort. Indeed, several of the cases discussed here were quite politicized and often substantively covered in the mainstream press, and invited the attention and even the comment of established political office holders. Moreover, organized interests were not only vocal in the merger processes, they were often direct stakeholders and even participants in the merger outcomes themselves – exchanges, but also banks in several cases where merger outcomes were influenced by the availability of alternative bank ownership structures. At the same time, the cases have illustrated several examples of, first, multivalent lobbying, i.e., lobbying that does not provide regulators with a single clear industry preference and thereby gives them scope to adjudicate and pick their own preferred outcome; and second, interested politicians sending certain political signals to electorates, but ultimately refused their preferences and/or not involved in the decision to intervene in the market for corporate control of exchanges.

In doing so the case studies have endeavoured to show that despite these rather public dynamics, regulators could still be meaningfully thought of as independent actors whose preferences were the most important causal factors in determining the outcome of these mergers. The significant takeaway here is that decisions need not be made beyond the public glare to be considered insulated, and what is more, it is important to move beyond the noise of interest group pressure and public commentary to seek the deep casual mechanisms driving towards observed outcomes. The independence of regulators from their political principals and the firms they regulate is far from absolute, and is in fact heavily circumscribed, but that does not mean

that political scientists are unable to find meaningful causality in the things that regulators want and do independent of those forces. This is a central claim of the dissertation with far-reaching analytical implications for subjects beyond financial regulation, wherever policy-seeking motivations co-exist with the observable interests of voters, politicians, and firms.

Perhaps the most significant contribution of this dissertation is related to this insulation dynamic: the finding that regulators' preferences regarding international financial market integration ought to be taken seriously as analytical subject matter. A substantial discussion in Chapter 3 identified the many explanations that political scientists have elaborated to date for the depth and scope of market integration, both within and beyond financial services. Of course, those approaches – including ideational, epistemic, power-based, or interest-group based explanations – are very often sufficient for explaining key phenomena, not least the steady expansion of cross-border financialization in the post-Bretton Woods period. It is important, then, to carefully identify that where regulators have preferences that are not efficiently explained by these existing and often compelling perspectives on policymaking, there may be alternative analytical strategies that can be deployed to fully understand a) why regulators seek the outcomes that they do and b) what drives them in situations where ideational, interest group, and related (traditional) explanations cannot account for the observed outcomes. Indeed, where there are reasons to expect that regulators have *sui generis* preferences that are not overdetermined by existing and well-established accounts in political science, regulators themselves are – and will increasingly be – appropriate subjects for careful analytical work.

This is not least because of their growing influence over market outcomes. Market regulators from the level of the international standard setters (such as IOSCO, Basel, the Financial Stability Board, and others) down to jurisdictions and even sub-jurisdictions have been

tasked in the post-crisis period with an unprecedented workload. Massive, omnibus pieces of financial legislation such as Dodd Frank in the US or EMIR and MiFID II in the EU have presented regulators with the task of developing thousands of pages of technical rules and standards that meet the requirements of the legislative text. This is frequently a task that is subject to both the preferences and judgments of those regulators, not least because the legislation is often open for interpretation, or many not specify particular mechanisms in the pursuit of particular legislative goals. Regulators' voices are arguably as loud in the financial markets in the post-crisis period as at any time in the era of global capitalism.

This is not to say that market liberalization has been reigned in. That is not the claim being advanced here, although it is empirically debatable, and varies across sub-sectors of financial services. Rather, the point is that the manner in which cross-border financial service activity is authorized, regulated, and monitored is, today, frequently largely – if not entirely – under the purview and discretion of regulatory authorities with mandates to make rules, i.e., rather than their political principals with legislative authority. Regulators are today able to impede or enable cross-border financial service transactions, either explicitly or by subjecting such transactions to duplicative requirements that make compliance nearly impossible. This phenomenon may not be entirely new but it is certainly more prevalent, and more material in terms of the markets it touches than at any time in the history of global finance capitalism. This gives clear impetus to the need to better understand why regulators respond the way they do to certain instances of cross-border market integration, which this dissertation has taken a step towards doing.

Finally, in assessing the theory's broader implications it is necessary to consider the degree to which the theory can be expected to apply more generally than the narrow realm of

market infrastructure firms in financial services. There are reasons to expect that the underlying causal relationships identified in the theory would in fact travel well to different contexts, but there are also some limitations due to the nature of the cases selected – and indeed, the industry that has been analyzed in this dissertation – that should be briefly considered.

In general, there are good reasons to expect that heavily regulated industries with significant distributional implications are likely to feature similar dynamics – especially those where key firms within that industry are significant national players under pressure to consolidate on a cross-border basis (i.e., telecoms). Regulators tasked with ensuring the delivery of critical outcomes in different sectors – for instance, postal delivery or telecoms infrastructure in remote areas, or safety testing for certain important consumer goods – are likely to consider the impact on their ability to achieve those outcomes in a more internationalized context versus a purely domestic one. There is no *ex ante* reason why the theory presented in this dissertation would only apply to regulators of specific types of firms, and indeed, independent, professional, policy and office-seeking regulators ought to be motivated to do their jobs well in any context – and to face costs to that job-execution as a result of commercial arrangements that are more complex or more opaque to monitor. To the extent that regulators are indeed motivated in this way, and face these costs, and take action only where their ability to execute their jobs is affected due to historical institutional configurations of regulatory and market power, then the theory has broad application. It is reasonable to expect that these considerations become salient in many contexts where regulation is broadly interventionist in nature.

Moreover, this condition – the presence of a strong regulatory agenda and/or significant regulatory preferences for certain outcomes – does not necessarily present a significant barrier to

the external validity of the theory, because the degree of regulation in any particular sector is likely to be endogenous to the severity of the distributional implications and trade-offs at the core of that sector. That is, cross-border mergers are likely to be subject to the logic of regulator dependence only where there is a robust set of expectations facing regulators because, bluntly, the sector “matters” – but this is not a substantial limitation. While financial services are clearly one such industry, it by no means the only one to feature these high-level dynamics.

That said, there are three potential limitations on the external validity of the theory tested in this dissertation. First, there is a strong requirement that regulators have political space to act on the basis of their *sui generis* preferences for the theory to have purchase. This is a stipulation that could certainly confound the applicability of the theory in circumstances where regulators are either systematically denied such a political space, or denied it for more *ad hoc* reasons on an issue by issue basis. The theory thus contains a significant and constraining scope condition, which is that the conditions for insulation must be in place and must be observable. In certain jurisdictions or, indeed, sectors where the agency model is not as widely used for the purposes of private sector regulation, the theory may not apply as readily as it does in the cases discussed here. Similarly, where business lobbying is more unified, assertive, and/or centrally coordinated, then the theory may be expected to fall away to standard theories of regulatory capture and endogenous policy outcomes.

Second, the case studies included in this dissertation do not allow include economies often referred to (in the VOC typology) as coordinated market economies, or CMEs. In these jurisdictions, including Germany and other corporatist European states, economic institutions (including the financing, training, and labour relations institutions) that have emerged in the post-war period are marked by deep interdependencies that allow for corporatist styles of co-

decision making and joint planning on a national scale. The impact is one in which investments are driven by long-term gains rather than short-term efficiency-seeking, and typically the small and regional banks – as well as the regional stock markets in Germany – have played a dominant financing role for small and medium sized enterprises. In such a system it is conceivable that insiders would be in a privileged position vis-à-vis a domestically managed stock exchange group and would therefore seek to impede any international merger involving such an institution (cf. Callaghan 2014). While it is equally possible that the particular systems of dependence that are in place in a CME are linked to the same sort of historical institutional developments as other types of jurisdictions – i.e., the theory could explain the development of dependence in CMEs as well – there is simply not a clear outcome in which a CME like Germany (or indeed, Japan, a somewhat different type of economy with strong state-business links) has had to make a decision on a merger. The case discussed in Chapter 7 was not brought to the German authorities for a final decision. At present, the degree to which this type of jurisdiction is subject to the same causal mechanisms outlined in this dissertation is unknown – despite there being reason to expect the underlying logic, namely the impact of institutional configurations of market and regulatory power, will have purchase in such economies.

Finally, it is possible that there is something unique about market infrastructures that lends them the particular political dynamics that have been observed and theorized in this dissertation. The admixture of several key features in a specific sub-sector are relevant here: utility-like functions and public-good provision; a history of notable self-regulatory capacity and ongoing expertise; the fact that exchanges underpin financial markets, a technically complex and often opaque industry; and the mobile nature of financial market flows. While the same list could reasonably be ascribed to the banking sector, it is not obviously the case that other sectors

of the economy beyond finance are as likely to feature all of these specific features, and it may well be that regulators of market infrastructures are simply unlike any other types of regulators for these reasons. It is worth considering this limitation on the general applicability of the theory, but it is important to note as a counterpoint that even absent some of these characteristics of the exchange industry, regulators are likely to be motivated by high-level concerns about their ability to execute on the things they have been tasked with doing. That being said, the absence of some of these characteristics of the exchange industry could well result in dependence being a rarer state of affairs, or simply a higher threshold to reach in the minds of different types regulatory actors who are nevertheless equally worried about their job-execution – it may simply be that the cost-based mechanism is still active but not as easily activated for regulators in other industries not featuring the same admixture of complexity, mobility, and utility-like functions. That would be an interesting observation in itself, and worth testing to uncover the general applicability of the theory of regulator dependence on a sliding rather than a static scale.

### **Beyond the dissertation: questions for future research**

What does the theory of regulator dependence offer beyond the narrow subject matter scope of exchange industry integration, in other political and policymaking contexts? While the cases demonstrate a high degree of consistency with the predictions of the theory, they also point to an unexplained but causally significant dynamic, one that goes beyond the dependency-based explanation presented here (while remaining consistent with the underpinning assumptions of the theory, namely that regulators care about, and seek to buttress or protect their power resources where it is threatened by cross-border firm-level integration). In three cases regulators can be observed shoring up their regulatory authority in order to enable subsequent levels of

international integration; notably, they did so in response to integration that had been seen as problematic in the context of a specific merger proposal. In the UK, one of those decisions is the Ed Balls legislation driven by the UK FSA that was discussed in the TMX-LSE merger as a previous decision regarding the allocation of regulatory authority. This legislation removed any vestigial regulatory authority from the LSE and scaled it up to the state via the UK Listings Authority, ensuring that going forward the regulator would have substantially fewer concerns about where the management of the LSE was located, because it had all the relevant regulatory powers itself. The Australian prudential authorities' post-merger proposal review of the powers it would need over a cross-border clearinghouse entity is another case of policymaking in response to a failed merger. Here, the proposal to impose certain "location requirements" on firms providing systematically-important market services again served to reduce the importance of the firm being uniquely operated and/or managed out of Australia, because regulators would have in place the location-based "hooks" they needed over certain essential firm decisions, including the allocation of capital resources. Finally, although regulators in the EU and US did not block the NYSE-Euronext merger, they, too, put in place strategic, control-enhancing conditions for the merged entity that also shored up their existing capacities to compel the firms to follow certain undertakings and avoid others, for use in scenarios of conflict or concern in the future. These included the 'Stichting' arrangement and other requirements placed at the level of the NYSE-Euronext holding company to ensure that regulators could compel the firm to divest itself of its component parts at a later date if their power was threatened or eroded. It is also worth restating here that in the European Commission case, EC officials expressed concerns about the DB-NYSE-Euronext merger from the perspective of its subsequent impacts on their

autonomy, namely that they were find themselves increasingly dependent on that single exchange infrastructure firm, which they perceived as a threat to their future power.

These decisions suggest two things: first, that regulators are forward-looking and strategic not only with regards to the potential costs of mergers down the road, but also with regards to what an alternative policy structure might look like; and second, regulators that have concerns about mergers that are so significant that they seek to interfere in the market for corporate control *also* appear to be interested in avoiding the need to bluntly intervene in the market for corporate control in the future. Putting these two observations together suggests that regulatory authorities with concerns about integration do not necessarily want to impede it, and in fact, consider how to enable it going forward – and take concomitant steps to do so.

This is an important observation. It suggests, first, that cross-border integration proposals are moments where regulators consider not only the immediate ramifications of the proposed integration, but also how their own capacities may be protected going forward. In short, integration proposals appear to be moments where policymaking innovations are likely. What is more, in looking at the types of innovations identified in the previous paragraph and discussed in depth in the empirical chapters, it appears that regulators not only block threatening mergers; they also use the opportunity of a specific proposal to think about how to give themselves more capacities, tools, and teeth over cross-border market phenomena going forward. Significantly, this suggests that in an era of substantial material and normative pressure to integrate financial markets on a cross-border basis, regulators not only have strong incentives to seek tighter control over exchanges and related financial market entities, but are also actively seeking to create new ways to manage that integration. Regulators thus appear to be imposing new rules to enable more integration in the future.

It is unlikely, however, that merger proposals provide the only – or even the most common – impetus for a regulator to assert tighter control over the firms they regulate. In addition to the reactive responses to mergers (i.e., mergers *qua* catalysts for policy innovation), historical policy decisions about the degree of oversight and control regulators have over the market are theoretically significant themselves: i.e., how “loose touch” or interventionist regulators have historically been in particular financial policy areas. If regulators can exercise greater or lesser degrees of control over the firms and markets that they regulate, and these choices have implications for the degree to which regulators are supportive of the cross-border integration of those firms and markets, then the causes and conditions under which they do so matter. In short, if strong mechanisms of oversight and control are increasingly tied to public officials’ support for cross-border integration – a strongly counter-intuitive but logical finding – then when, short of merger proposals, do regulatory authorities develop and implement such strong mechanisms of control?

Stated differently, the antecedent policy conditions that result in greater or lesser degrees of dependence are exogenous in the framework elaborated here, but they are important. It is a shortcoming of the theory presented here that they are not endogenized, and the responses by UK, Australian, and European authorities to different merger proposals serve to bring that *lacuna* into focus. This suggests that meaningful contributions could be made towards a political economy explanation that disentangles self-regulation vs, “tight control” by public officials, for example, and elucidates the conditions under which one or the other choice is likely to be more or less politically feasible or attractive. The relationship between these choices and subsequent market internationalization is a promising line of inquiry.

The observation of regulator dependence in the exchange industry – and the identification of its causes – leads to two additional lines of inquiry that are potentially fruitful for advancing our understanding of both cross-border regulatory politics as well as public decision-making on market integration. Most obviously, the theory of regulator dependence should be tested in sectors beyond the realm of market infrastructures. As stated above, there are reasons to expect that market infrastructures might be given to certain territorial logics, not least because they have historically been the hubs around which a variety of financial service activities have been organized. For this reason, it would be worth counterpoising this type of financial service firm against another, for instance an investment bank with manifold branches and subsidiaries across jurisdictions, to discover whether the commercial activities that they undertake are perhaps – or perhaps not – subject to similar regulatory concerns in certain conditions. Such research could helpfully consider both similar financial services markets (like banking services, insurance) as well as dissimilar markets (food production, resource development) with an eye not only to whether the theory’s expectations travel as expected to different markets and products, but whether unexpected variables play causally significant roles – for instance, the “rootedness” of the products or benefits that are generated in different markets or sectors. It is likely to be generally true that domestic distributional considerations come into play regarding cross-border mergers involving large and powerful firms in many sectors – the key question in need of further investigation is, what specific and independent roles do regulators have in shaping decisions relating to cross-border mergers and acquisitions in the banking, mining, or agricultural sectors? How do those roles vary across sectors or perhaps countries? What causes them to vary?

These questions could add new and exciting research findings to existing political science literatures, including approaches that consider the relative mobility and/or fungibility of factors

such as labour and capital in determining macro-political decisions regarding market structure or regulation. Perhaps incongruously, these findings could also contribute to a seemingly discordant development literature regarding the sources of conflict and violence related to the “resource curse” based on how mobile or fixed certain resources are in particular physical locales. Resource economies in developing jurisdictions, much like certain product markets in the service economy, may create territorially-bound concerns for political actors in those jurisdictions about the ability to meet certain political objectives, and about the degree to which foreign ownership, processing, or profiteering from those resources militates against the realization of those distributional objectives. In such instances, political violence, nationalization, and other strategies not necessarily familiar to observers of the financial markets may, in fact, be based on a similar logic of officials enacting territorial constraints in response to a cross-border market’s impact on their capacity to meet domestic goals.

Finally, the findings here ought to be expanded within the realm of political economy to consider the simple fact that, in finance as well as in other transaction-based industries (such as information technology) and transaction-based policy domains (such as taxation), a considerable degree of internationalization is already a fact that regulators must deal with, rather than a potentiality to contain or allow. How can the insights generated in this dissertation be applied to sectors featuring heavily-regulated firms that have already integrated on a cross-border basis (like cross-border banks)? Regulators clearly care deeply about their influence over the market transactions and private undertakings that have an impact on their job performance – but where impeding cross-border integration is not feasible (i.e., it has already happened), does intervention based on regulator dependence take other forms? In particular, the use of extraterritorial provisions by domestic authorities would appear – at first glance – to be propelled by many of

the same concerns about how firms' actions both at home and abroad affect regulators' pursuit of policy goals. Furthermore, extraterritoriality is now a fact of international economic life, especially in the context of the new rulesets being developed in the post-crisis period, and discussed above (see Gravelle and Pagliari, forthcoming). Subsequent research should build on the theory of regulatory protection to better understand when and why regulators deploy extraterritorial rather than protectionist tools in the pursuit of domestic policy goals (Putnam, 2009; Raustila, 2009). Intervention in the market for corporate control is unlikely to be the only observable effect of the underlying regulatory concerns identified in this dissertation, and future research should turn to its more internationalized variants to better understand the steps that public officials take to shore up their power when faced with the internationalization of firms, transactions, and markets.

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