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**VIA E-MAIL**

**Comments to the Ontario Securities Commission on the Proposed Transaction Involving TMX Group Inc., TSX Inc., and the London Stock Exchange Group PLC**

I have been retained by the TMX Group Inc. ("TMX") to respond to the request of the Ontario Securities Commission ("Commission") for comments on the proposed transaction between TMX and the London Stock Exchange Group PLC ("LSEG"). The opinions expressed in this response are my own. Before I was in contact with counsel for TMX I believed that this transaction ought not to pose a problem for the Commission; having now researched the matter further, I believe even more strongly in this conclusion. For reasons I set out in this response, allowing this transaction would not meaningfully affect the Commission's oversight of TMX in the short run, and would strengthen the Commission's oversight in the medium to long run.

I will in this response offer my reactions to the Commission's clear and thoughtful Notice and Request for Comment dated May 13, 2011. As invited by the Notice, I would request the chance to discuss my submission with the Commission in person at a public hearing in July. I do not propose responding to each question in the Notice document serially, but rather will focus on

two broad themes that have relevance in answering many (though not all) of the specific questions the Commission poses.

The first section of my response reviews the regulatory implications of the proposed transaction if it were to be approved. This section discusses existing regulatory protections and changes to these protections that the transaction would entail. It is my belief that the transaction would not materially affect Commission oversight of TMX and TSX Inc. ("TSX"). While there would be some changes in the regulatory framework associated with the transaction, none of the changes jointly or severally would significantly impact the Commission's ability to regulate TMX and TSX and Ontario capital markets.

The second section of this response focuses on a different question that I believe to be equally vital to the Commission's deliberations on the proposed transaction: What are the regulatory implications if this transaction is *not* approved? One may be tempted to conclude that disapproving the transaction would preserve the regulatory status quo. In my view, however, the regulatory status quo would be in *greater* jeopardy in the medium to long run from a *failure* to approve the transaction. Stated briefly, the argument is as follows. There is a global trend to the consolidation of exchanges. This trend reflects, among other things, economies of scale, in people, but especially in technology, as well as increased competition between exchanges; exchanges are merging in part because they need to be efficient to face competitive threats from other foreign and domestic exchanges. If the transaction is not approved and TMX cannot pursue its preferred strategy to realize efficiencies that its competitors have realized, TMX risks losing (further) market share amongst Canadians to foreign exchanges. This loss of business would undermine the Commission's ability to regulate the exchanges on which Ontarians and

Canadians are trading. It would be shortsighted to conclude that rejecting this proposal would protect the regulatory status quo.

In the third, concluding section, I review the bottom line implications of the analysis. On the one hand, allowing the transaction would result in minimal changes to the regulatory framework presently in place, while at the same time allowing TMX to equip itself better to meet the challenges of a globalizing marketplace for exchange services. This in turn preserves significant Ontarian and Canadian oversight over a vital, Ontario-based exchange. On the other hand, disallowing the transaction would in the short run avoid marginal changes to the regulatory landscape, but in the longer run may reduce the importance of TSX as an exchange for Ontarians and Canadians, which in turn would undermine the oversight role of Ontarian and Canadian regulatory institutions, and the Commission in particular. It is my view that there are clearly greater risks to the Commission's authority in the medium to long run from not allowing the transaction than from allowing it.

Before turning to the body of my comment, let me discuss briefly the central criterion on which I rely in the following to evaluate different regulatory alternatives. I take it to be the key objective of the review process of this transaction that the regulatory status quo be preserved as much as possible. That is, my analysis and conclusions about the desirability of the proposed transaction take the present approach of the Commission to regulation as given and appropriate. This is not to say that there is no room for debate on the status quo, but rather that arguments for or against the status quo arise independently of the proposed transaction and are better left for another day. I will judge the proposed transaction on the basis that the Commission's regulatory reach under the status quo is optimal.

Having said that, allow me to make one prefatory remark on the status quo. The Commission invites comment on the regulatory implications of the proposed transaction. These implications concern the authority of the Commission to oversee exchanges in Ontario. While I intend to focus on the question of whether the transaction would significantly affect the Commission's authority, it is worth recalling as a background observation that there is good reason to predict that exchanges will generally have strong incentives to offer rules and regulations that are in the public interest.[1] If listing requirements become lax, for example, the reputational benefits of listing on the exchange diminish, which hurt the bottom line of the exchange. Similarly, if the exchange fails to regulate trading appropriately, many traders would not want to trade there, thus diminishing liquidity and the exchange's profits. While the existence of Commission oversight under the status quo reflects unease about complete reliance on market-driven incentives, it is at the same time worth noting that the Commission generally allows the exchange considerable discretion on a number of key institutional questions. TSX promulgates and adopts its own listing requirements, for example, subject only to Commission approval. This implies that while Commission regulation of exchanges exists and is potentially important, the incentives of an established exchange like TSX to self-regulate in a socially desirable manner are implicitly recognized with the deference that the Commission presently shows to TSX. This suggests that changes in the regulatory framework governing exchanges, even if they were significant (which I do not believe they would be under the proposed transaction), ought to be viewed with less concern than changes to other areas of regulation where private and social interests more obviously diverge.

[1] See, e.g., Paul Mahoney, "The Exchange as Regulator" (1997) 83 University of Virginia Law Review 1453.

**I. Regulatory Implications if Transaction were Approved**

The Commission invites comment on issues relating to the recognition of exchanges, exchange ownership restrictions and exchange governance following the transaction. I consider each topic in turn.

(i) Exchange Recognition

At present, the Commission recognizes both TMX and TSX as exchanges. If the transaction were approved, the Commission would continue to recognize both TMX and TSX, but would not have jurisdiction to recognize "Mergeco", the entity that will be the sole shareholder of TMX. The Commission asks whether the proposal therefore jeopardizes potentially important regulatory oversight; Question 2, for example, asks whether "Mergeco's proposed undertakings to the Commission provide for a sufficient degree of regulatory oversight by the Commission over the operations of TMX Group, TSX and Mergeco as necessary?" In my view, the answer is yes. (Note that I leave for later discussion questions about ownership and governance restrictions that may be related to exchange recognition.)

As a fundamental preliminary matter, TMX and TSX cannot operate as an exchange in Ontario without the Commission's recognition. Nothing would change in this respect post-transaction. Therefore, if TMX or TSX takes actions that the Commission perceives to be against the public interest, the Commission would continue to wield the most significant power it presently holds of withdrawing recognition.

It might be suggested that such authority is useful, but there would be considerable constraints on its invocation given the profound implications that this would have for Ontario capital markets. I would agree that it is very unlikely that the Commission would ever find itself invoking such powers, but that is because it would be very unlikely for Mergeco, TMX or TSX

to pursue strategies that would fundamentally alter their relationship with the Commission. Removal of the recognition of TMX and TSX would have profound effects on Ontario capital markets, but would also very clearly have profound effects on the business of TMX and TSX. With such a backdrop of undesirable consequences, it is predictable that the merged entities would seek to operate in a manner acceptable to the Commission. This fundamental relationship exists now and would not change following the transaction. The root of the Commission's authority, with associated implications for moral suasion and other less formal means of regulating, would remain unchanged.

In addition, the Commission would retain its general authority to make orders in the public interest. This allows the Commission scope to make orders requiring TMX or TSX to make changes that better comport with regulatory objectives, perhaps orders to cease and desist from certain actions, or perhaps orders requiring changes to the directors or officers of the entities. This authority provides the Commission with concrete regulatory powers, but also with the practical authority to rely on less formal means of exerting influence: TMX and TSX would operate in the shadow of the Commission's public interest powers.

In addition, it is clear that while Mergeco would not be recognized by the Commission, much of the significance of recognition orders relates to specific choices made by the actual exchange, TSX, not the parent or grandparent company. For example, it is TSX, not TMX or Mergeco, that charges fees for its services. The Commission may continue post-transaction to ensure that these fees are reasonable without any jurisdictional question arising. It is TSX, which may contract some of these services out, that regulates the listing of issuers and trading. The Commission may continue post-transaction to ensure that these efforts are appropriate.

In addition to the continued direct regulation of specific decisions that the exchange makes, Mergeco has offered of a number of undertakings that would also preserve important practical aspects of the Commission's regulatory authority. For example, Mergeco has committed itself and its subsidiaries to providing financial and other data and information to the Commission that are necessary for the Commission to evaluate the regulatory performance of TSX. Mergeco commits to allocate sufficient resources to its subsidiaries to ensure that they can carry on business in the public interest. Mergeco commits to the continuing operation of TSX with local management. There are also undertakings on ownership changes and governance that I discuss below. Aside from constituting part of a contract with the Commission, these undertakings are "securities law," given that they would form part of the decision of the Commission to approve the transaction[2], thus conferring a wide range of enforcement powers on the Commission against Mergeco.

The combination of the Commission's continuing authority to recognize TSX and TMX or not, the Commission's continuing public interest powers, the continuing direct oversight of TMX and TSX on specific matters, and significant undertakings directly enforceable against Mergeco would result in a regulatory regime that essentially establishes the Commission's effective authority over Mergeco that formal recognition of Mergeco would entail. In short, there would be no meaningful diminution of the Commission's authority in this respect.

(ii) Ownership Restrictions

At present, TMX cannot under the terms of its recognition order have a shareholder owning more than 10% of its shares without prior approval of the Commission. If the Commission approves this transaction, the recognition order would continue to apply to TMX

[2] Section 1.1 of the *Ontario Securities Act* defines "Ontario securities law" to include the decisions of the Commission in respect of a person or company.

and TSX such that no investor could become a 10% shareholder without the prior approval of the Commission.[3] What would change, however, are the ownership restrictions that apply to the holding company, Mergeco under the proposal, that would own TMX and TSX. The Commission would not have authority to regulate ownership of Mergeco directly, but the continued application of existing ownership restrictions under the articles of TMX and the Ontario Securities Act would require Commission approval of any de facto or de jure change in control.

In my view, these changes to ownership structure and its regulation would not bring about a material difference to the Commission's regulation of Ontario exchanges. Ownership restrictions are in place to address conflicts of interest that may arise between a substantial shareholder and other stakeholders of the exchange, including the public. It is worth noting as a preliminary matter that any particular manifestation of such a conflict, such as a change in the fees or a change in listing requirements designed to benefit the substantial shareholder at the expense of other stakeholders and perhaps society, would itself continue to be directly regulable by the Commission under its specific or its public interest powers. Even in the absence of ownership restrictions, the Commission has practical means to address any manifestations of a conflict of interest ex post rather than restricting ownership changes ex ante. This is not to say that ex post and ex ante regulation are perfect substitutes (recall my foundational assumption that the regulation presently in place is justified), but it is to put in context the significance of the ex ante ownership restrictions. Ownership restrictions do not lie at the core of the Commission's regulatory toolkit.

[3] In addition, the parties propose an undertaking that would require prior Commission approval of any sale of TMX or TSX shares to a third party.

In addition, the directors of the subsidiaries, TMX and TSX, would remain subject to direct Commission oversight; any capitulation by them to the self-interest of a major shareholder of Mergeco would invite a regulatory response by the Commission.

Another relevant consideration is that conflicts of interest between a major shareholder and other stakeholders, especially other shareholders, are less likely to manifest in practice where a major shareholder is not a controlling shareholder. While a major shareholder may have influence, it will clearly fall short of the influence wielded by a controlling shareholder.[4] Mergeco post-transaction would not have a controlling shareholder, and the current Ontario ownership restrictions structure will continue to apply to any change in control, de facto or de jure, of Mergeco. This leaves the Commission with direct authority over the most important ownership issue.

It is also necessary to recognize the restrictions on ownership of Mergeco that would arise as a result of UK law. First, under the UK Takeover Code, any shareholder acquiring 30% or more of the voting shares must make a mandatory offer for the rest of the shares, and must acquire more than 50% of these shares for its acquisition to proceed. This implies that, for all practical purposes, the Commission would move from approving any new 10% shareholder of the ultimate parent of TSX to approving any new 30% shareholder. Moreover, any new 10% shareholder of Mergeco would require the approval of the UK Financial Services Authority (FSA). The FSA, an internationally respected agency, is unlikely to allow a 10% shareholder where doing so would lead to conflicts between stakeholders of the larger enterprise.

It may be sensible for the Commission and the FSA to enter into some kind of agreement in which the FSA commits to consulting with the Commission in the event of an ownership

[4] This is recognized in the Ontario Securities Act, which defines a takeover bid based on minimum ownership of 20% of the voting shares of the acquiree.

change over which the Commission does not strictly have authority. Indeed, in my view such an agreement to consult would make sense even where (or maybe especially where) both agencies simultaneously have an authority to approve a change in ownership. This transaction, in my view, reflects a general trend toward the increasing global integration of capital markets, alongside which there has emerged greater cross-border cooperation between regulators. For a number of reasons, it would be sensible for the Commission and the FSA to enter into a cooperative arrangement, just as other regulators have done in analogous transactions in the recent past.[5] For one, the combined information set of both regulatory bodies together would be larger than that of either body. For another, if each regulator were to exercise its authority in an independent manner, this would systematically lead to excessively strict regulation. For example, if authorities sometimes err by forbidding change to ownership where such a change would be benign in fact, and other times err by permitting change where such a change would be undesirable in fact, a regime that has multiple regulators independently deciding the question would systematically allow too few changes: all it takes is one regulator to err by forbidding change where it should be permitted. From a global perspective, then, greater cooperation across borders to address regulatory matters that have relevance across borders would be desirable. This transaction, in my view, offers a context where such cross-border cooperation would be welcome from a policy perspective.

[5] A number of regulators in other jurisdictions have entered into memoranda of understanding following cross-border mergers involving stock exchanges. For example, the Authority for the Financial Markets (Netherlands), the Autorité des marchés financiers (France), the Banking Finance and Insurance Commission (Belgium), the Comissao do mercado de valores mobiliários (Portugal) and the FSA entered into a memorandum of understanding regarding the coordinated regulation and supervision of the European regulated markets operated by the Euronext Group and Euronext N.V. These same regulators, which comprise the College of Euronext Regulators, also entered into a memorandum of understanding with the U.S. Securities and Exchange Commission to facilitate cooperation in market oversight regarding the combination of NYSE Group Inc. and Euronext N.V. to form NYSE Euronext, Inc. The Finansinspektionen (Sweden), Rahoitustarastus (Finland) and Finanstilsynet (Denmark) entered into a memorandum of understanding regarding the supervision of OMX AB and its subsidiaries. The FSA and Commissione Nazionale per le Società e la Borsa (Italy) have entered into a memorandum of understanding in connection with the supervision of London Stock Exchange plc and Borsa Italiana SpA, which are both operated by London Stock Exchange Group plc.

Having said that, I would not make approval of this transaction contingent on such international cooperation. If it were categorically true that the emergence of a major shareholder for TMX would be a negative development, the present regulation of ownership would be strictly prophylactic. It is not. The Commission presently has the authority to approve a 10%-plus shareholder of TMX and TSX. This transaction seems to be precisely the kind of case where such approval is appropriate: there would be no controlling shareholder following the transaction; the Commission would retain authority over ownership of TMX and TSX going forward; the Commission would retain authority over specific decisions of TMX and TSX and their directors (including ordering their replacement under its public interest powers) and thus would have tools to address any manifestations of a conflict of interest that might arise from an ownership change; extensive undertakings ensure that the Commission would retain wide authority over Mergeco; the Commission would retain authority over de jure and de facto changes in control of Mergeco, the most important ownership issue; because of the UK Takeover Code, the Commission would effectively retain authority over the emergence of a 30% shareholder at Mergeco; and the FSA, a respected agency, would have authority over the emergence of a 10% shareholder of Mergeco. These considerations are sufficient, in my view, to address any potential concern about the Commission's authority over ownership; the opportunity to collaborate with the FSA simply reinforces this conclusion.

(iii) Governance

The proposed transaction would bring about change to the governance of TMX and TSX. The emergence of Mergeco as the ultimate parent would diminish Canadian representation on the board of the ultimate parent of TSX, and there is some possibility that certain important decisions relevant to Ontarian and Canadian exchanges will be made overseas. In what follows I

assume that the Commission's interest in these matters does not arise out of nationalism concerns,[6] such matters are better left to the Investment Canada Act, but rather the interest arises out of concern that regulation of foreign nationals would be more difficult or less effective than regulation of Canadians and Canadian residents.

I note as a preliminary matter that the Commission's current regulatory regime does not directly regulate the location of the decision-making processes of TMX and TSX, or of the nationality or residence of directors. While there may have existed a presumption that such Canadian content would arise naturally given the domestic nature of the exchange group, in my view, it is also true that the nationality or location of the decision-makers is not terribly significant to regulation. The TMX and TSX are profit-maximizing entities. If there are strategies that are profitable but potentially harmful to Canadian capital markets, a regulator would be naïve, in my view, to rely on patriotism or the location of decision-making to deter privately optimal but socially harmful choices. This is not to say with certainty that nationality is entirely irrelevant, but it is to say that its significance in practice is not self-evident. Even if nationality were properly viewed as part of the regulatory framework, which I will accept for the sake of argument in what follows, it should not be viewed as central, in my view.

In any event, the governance arrangements that are proposed in the transaction successfully address any concerns that may potentially arise from the "de-Canadianization" of TMX and TSX because of Mergeco's ownership. First, and most important, the Commission would continue to have direct oversight of TMX and TSX. If TMX and TSX attempt to pursue strategies that are not in the interests of Ontario and Canada, the Commission has the authority to address these strategies explicitly and directly.

[6] The Commission rightly notes in its Notice letter, for example, that restrictions on ownership changes presently in place do not touch on foreign ownership at all.

In addition, the proposed amendments to the recognition orders of TMX and TSX significantly enhance formal commitments to Canada. The proposed amendments would ensure, amongst other things, that: the head office and executive offices of TMX and TSX will be in Canada; the CEO of TMX will be resident in Ontario; the CEO and senior management of TSX will be resident in Ontario; TSX will be locally managed; all regulation functions will be carried on in Canada; and a majority of directors at TMX and TSX will be Canadian residents. Even if one were to view Canadian residency as being a non-trivial requirement for effective regulation, when one examines the range of important activities and decision-makers of the entities directly operating the exchange that are required to be in Canada post-transaction, it is apparent that this requirement is met.

To be sure, there is an important qualification that requires discussion: while the head offices of TMX and TSX would be in Ontario, and a majority of directors would be Canadian residents, the parties frankly observe that the decision-making of these subsidiaries would be subject to strategic and policy guidance set out by Mergeco. Mergeco would not be located in Ontario. This would weaken the links to Canada, but in my view not enough to cause concern (again, accepting the premise that "Canadianess" matters to regulation). First, Mergeco has undertaken to nominate a significant number of Canadians to the board of Mergeco. Barring further acquisitions, at least 7 of 15 directors would be Canadian over the next 4 years, and after that no fewer than 3 directors would be Canadian. This ensures that the board of Mergeco would have access to the distinctive (by hypothesis) viewpoints that Canadians would bring to its business. Moreover, it is not plausible to predict that a parent corporation with operating subsidiaries would not canvass the views of the executive team and directors of the subsidiaries when setting overall strategies. Because of the dominant presence of Canadians on the

subsidiaries, this too ensures that Mergeco would have considerable input from Canadians in the process of setting overall guidance.

Second, while Mergeco would set the overall direction of the combined exchanges, TMX and TSX would be distinct corporate entities operating the exchanges in Canada. Their directors would largely be Canadian, and they would owe fiduciary duties to TMX and TSX under Canadian law. Under Canadian law, fiduciary duties to the corporation have been interpreted broadly in recent Supreme Court decisions.[7] The duties are not owed to shareholders, but rather to the corporation, period. What this precisely *requires* is not clear, in my opinion,[8] but what it *permits* is much broader than a duty to shareholders. In particular, directors of TMX and TSX may act consistently with their fiduciary duties if they view the effects of their decisions on the broader public as relevant to the evaluation of the best interests of the corporation. In the present context, for example, it is noteworthy that the directors of TMX, when considering this transaction pursuant to their fiduciary duties, considered not only the shareholder gains available from the transaction, but also the impact of the deal on Canadian capital markets. Such a view of fiduciary duties would continue to be permissible post-transaction, and of course would not vary across directors of TMX or TSX according to residency or nationality. As a consequence, if the strategic direction of Mergeco is inconsistent with what is good for Canadian capital markets, even if good for their shareholders, directors of TMX and TSX may view themselves as duty-bound to oppose it.

I would not want to overstate the constraints that the fiduciary duty would impose on directors of TMX and TSX, given that fiduciary law in Canada under *BCE* and *Peoples* provides

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[7] See *BCE Inc. v. 1976 Debentureholders,* 2008 SCC 69; *Peoples Department Stores v. Wise*, [2004] 3 S.C.R. 461.
[8] See Edward M. Iacobucci, "Indeterminacy and the Canadian Supreme Court's Approach to Corporate Fiduciary Duties" (2009) 48 Canadian Business Law Journal 232.

more flexibility than constraints, and that there would be practical incentives for directors who wish to keep their jobs to defer to the wishes of a 100% shareholder. But while fiduciary duties may not be a dominant constraint or source of motivation for directors, it seems to me reasonable to suppose that they would be as powerful an influence at a for-profit business as a director's nationality or residence.

In summary, the Commission would continue to wield considerable direct authority over TMX and TSX; this is in my mind overwhelmingly more significant for regulation than the nationality and location of decision-making and decision-makers. Moreover, on the assumption that there is some residual role for nationality, TMX and TSX would be dominantly Canadian, while Mergeco itself has committed to significant Canadian input. Even on the assumption that nationality matters to some extent to effective regulation, this transaction presents no material concern.

## II. Regulatory Implications if Transaction is Disallowed

I have reached the conclusion that allowing the transaction presents no significant threat to the Commission's authority under the regulatory status quo. In this section I consider the potential impact on the Commission's reach if it were to disallow the transaction. While in the short run preventing the deal would obviously preserve the status quo, in the medium and long run I believe that disallowing the transaction would have the potential to undercut dramatically the authority of the Commission. Given the starting premise that preserving the regulatory status quo is desirable, disallowing the transaction would thus present a significant concern.

Exchanges are facing significant upheaval. While historically, many countries had one or two exchanges that dominated the domestic trading market, there has been a recent trend to

increasing competition from both domestic sources, such as alternative trading systems[9], and international sources, including foreign exchanges.[10] In an excellent review of trends and likely outcomes in the exchange business, Lee predicted that the competition will become so fierce over time that exchanges will in effect become media businesses with their key asset being pricing and related data.[11] This is because with new and evolving technologies, the marginal cost of trading will essentially be zero. Competition pushes pricing down to marginal cost, hence revenues from trading will, Lee predicted, decline to insignificance over time. The pricing information that exchanges generate will become their key asset.

Competitive pressure not only pushes prices down, but also forces businesses to minimize costs. If one firm has higher costs than the competitive norm, it will not remain in business long. Both theory and evidence suggest that there are considerable economies of scale in the exchange business. As a matter of theory, there are potential savings from head office rationalization, but even more importantly, the key input for exchanges is technology. There are significant economies of scale associated with the very large investments in technology that exchanges must make. The greater the number of listings and trades associated with a piece of technology governing trading, the smaller the average costs per trade.

Evidence supports this theoretical prediction about economies of scale. In their study entitled, "Are expansions cost effective for stock exchanges? A global perspective," Hasan and

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[9] See, e.g., Reuters, "Toronto Loses Market Share to Smaller Rivals" April 21, 2011, available online at http://www.financialpost.com/related/topics/loses+market+share+smaller+rivals/4652319/story.html (date accessed: June 21, 2011).

[10] See, e.g., Eric Chouinard and Chris D'Souza, "The Rationale for Cross-Border Listings" Winter 2003-2004 Bank of Canada Review 23. They report, for example, that the number of Canadian firms cross-listing on U.S. stock exchanges doubled in the twenty years prior to writing their article. They also note that foreign listings on the NY Stock Exchange doubled from 8.5% of listings to 17% over the decade 1994 to the end of 2003. At p. 27, the authors observe that, "The relationship between liquidity and interlisting is largely attributed to the global competition for order flow (i.e., trading volume). This competition causes exchanges to continuously look for ways to improve their trading processes in order to enhance market quality and maintain or attract order flow."

[11] Ruben Lee, "The Future of Securities Exchanges" (2002) Wharton Financial Institutions Center 02-14.

Malkamiki examine evidence of economies of scale and scope across 38 exchanges in 32 countries on 4 continents.[12] They examine cost effectiveness of the different exchanges and conclude that economies of scale, particularly in North America and Europe, are significant. For example, in the overall sample, doubling the value of trading on an exchange would increase costs by only 41%; in North America, doubling the value of trading and doubling the number of companies listed would increase costs by only 49%.[13] (In Asia, there were smaller scale economies, seemingly because of greater labour intensity.)

To provide insight into the specific sources of these efficiencies, in a different study, Hasan, Malkammaki and Schmiedel examine the drivers of efficiency in the performance of 49 exchanges located around the world.[14] They note that exchanges have "been spending enormous resources in upgrading their technology"[15] and ask whether this has translated into cost efficiencies. Their answer is yes. The percentage of an exchange's expenditures on technology out of total costs is a statistically significant predictor of the greater efficiency of that exchange.[16]

In an interesting study of the creation of the Euronext exchange, Padilla and Pagano examine the specific efficiency gains that resulted from that consolidation of French, Belgian, Dutch and Portuguese exchanges.[17] They consider the efficiency gains that resulted from the integration of both the trading and clearing platforms of the exchanges. The trading integration proceeded first and resulted in significant cost savings. As they observe at p.15, "The consolidation of two or more cash trading platforms into a single platform can deliver significant

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[12] Iftekhar Hasan and Markku Malkammaki, "Are expansions cost effective for stock exchanges? A global perspective" (2001) 25 Journal of Banking and Finance 2339-2366.
[13] *Id.* at 2357.
[14] Iftekhar Hasan, Markku Malkamaki and Heiko Schmiedel, "Technology, automation and productivity of stock exchanges: International evidence" (2002) Bank of Finland Discussion Paper.
[15] *Id.* at 7.
[16] See *id.* at Table 10.
[17] Marco Pagano, A. Jorge Padilla, "Efficiency gains from the integration of exchanges: lessons from the Euronext 'natural experiment'" (2005) LECG.

cost savings.  These are achieved primarily by eliminating duplication in IT infrastructure and in marketing and customer support teams."  The authors conclude that such savings were realized in fact by examining specific choices at Euronext on both IT expenditures and staffing.

In sum, the evidence supports what only seems logical in a technology and marketing driven business: there are significant economies of scale in operating an exchange.  There is another potential advantage associated with scale: liquidity.  Scale advantages for liquidity could result from at least two different sources.  One, if there are cost economies of scale, then lower costs of trading could have a positive impact on liquidity.  Two, if investors tend to exhibit a bias toward investing in one particular exchange, then the more investors associated with that exchange, the greater the potential for liquidity.  Nielsson examines the impact of the Euronext consolidation on the liquidity of the securities traded on the exchanges before and after the consolidation.[18]  He finds an improvement in liquidity.  For example, average bid-ask spreads relative to the value of the security (as measured at the mid-point of the bid-ask spread) decline on average in a statistically significant way following the merger.[19]  Nielsson finds that these gains are concentrated in large firms and firms with international exposure, which is consistent with the hypothesis that the merger facilitated trading in stocks of firms that were otherwise more likely to be known by international investors.[20]

There are potential cost and liquidity advantages from increased scale.  It is not surprising, then, that increased competition in recent years between exchanges has been coincident with a push to greater consolidation both internationally and domestically across exchanges.  As Nielsson observes at p. 230:

[18] Ulf Nielsson, "Stock exchange merger and liquidity: The case of Euronext" (2009) 12 Journal of Financial Markets 229-267.
[19] *Id.* at 260.
[20] *Id.*

> The business environment of stock exchanges has changed considerably in the last decade. The typical government or member owned, national stock exchanges have largely been replaced by for-profit, publicly listed exchanges. These transformed stock exchanges increasingly operate at an international level, offering world-wide menus rather than merely serving a national appetite. The transition has been accompanied by an immense increase in international stock exchange integration and co-operation. For example, stock exchanges have established strong operationalties with the usage of joint trading systems and the harmonization of regulations. Interestingly, this increased level of integration has recently taken a new turn as stock exchanges have sought partners to create fully merged identities. The most noteworthy merger activities include the Euronext merger, the OMX merger, the NYSE-Euronext merger, the NASDAQ-OMX merger and the merger between the London Stock Exchange and Borsa Italiana. [Footnotes omitted.]

In an increasingly competitive market for listings and trading, competition which arises from foreign and domestic sources of competition, including alternative trading systems, exchanges have sought partnerships in order to realize economies of scale and liquidity advantages. There have been a number of significant stock exchange collaborations, and especially outright mergers, in recent times, as Nielsson notes. Greater collaboration is the natural result of the combination of increasing competitive pressures on exchanges and the competitive advantages that scale provides. Why this collaboration takes the form of mergers rather than less drastic integration is also straightforward to explain. Commentators have noted that collaboration short of integration leads to severe difficulties in contracting between the collaborating partners.[21] Each partner would prefer to free ride on the efforts of others to invest in the partnership's success: the free-rider receives the upside of others' efforts through the sharing that the partnership entails, while avoiding the costs of these efforts. Contracts could attempt to address such free-rider problems, but writing out reasonably complete contracts that specify the obligations of each contracting party would be, to put it mildly, difficult. On the other hand, if two exchanges merge, the described free-rider problem disappears: the benefits and costs of investments in the joint entity accrue to only one body of shareholders. It is

[21] See, e.g., Lee, *supra*; Padilla and Pagano, *supra*.

understandable, then, that competitive pressures and scale advantages have combined to result in mergers and acquisitions. As Lee put it in 2002, before much of the recent consolidation in the industry, "Most exchange linkages will fail – unless they lead to a merger or acquisition."[22]

The business case for the transaction that LSEG and TMX offer in the circular to shareholders resonates with the outlined theory and empirical evidence. LSEG and TMX would be able to realize economies of scale and scope as a result of this transaction. Their investments in IT, for example, would be leveraged across a much wider base of trading and listings. Moreover, their efforts at marketing the exchanges, particularly given the complementary nature of the listings on the exchanges, would also benefit from integration. Such economies of scale and scope are much less likely to materialize in the absence of an international transaction like this, where pre-existing, significant global exchanges combine forces.

It is no accident that this proposed transaction is arising at a time of unprecedented consolidation in the global exchange industry. The trend to consolidation has been precipitated by a number of factors including technology, demutualization and greater international competition, which has pressured exchanges to achieve efficiencies. In light of the theory and evidence on scale economies discussed above, it is not surprising to observe that consolidation in the industry is self-reinforcing: consolidation will beget consolidation because competition will become even tougher as merged rivals realize competitive advantages associated with scale. I agree with Boyd Erman who, in a recent article in the Globe and Mail, concluded that the failure of this transaction would not maintain the status quo, but rather would lead to a "weaker" TMX in a globalizing world.[23]

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[22] Lee, *supra* at 10.

[23] Boyd Erman, "The real damage may be an orphaned TMX", June 27, 2011, accessed online at http://www.theglobeandmail.com/globe-investor/investment-ideas/streetwise/the-real-damage-may-be-an-orphaned-tmx/article2077779/. Date accessed: June 28, 2011.

The parties in the circular to TMX shareholders emphasize the business merits of this transaction that in large part depend on realizing scale. They also in their submission to the Commission note the advantages that Canadian market participants would realize as a consequence of these business advantages. These potential gains are certainly worthy of consideration; for example, empirical analyses of the Euronext case have revealed cost savings and liquidity gains following the transaction, and clearly such advantages are relevant to the public interest.[24] But in my view consideration of the business rationale for the transaction is also essential in answering the questions about the Commission's regulatory authority that the Notice and Comment letter poses. In particular, the Commission must ask itself what would happen de facto to its regulatory reach if the TMX and TSX do not realize the economies of scale that its global competitors are realizing and will continue to realize.

There can be, of course, no certainty in predicting how global exchanges will precisely evolve over time, but in light of the evidence on economies of scale and the trend to consolidation that they have precipitated, in my view in the medium to long term the Commission risks weakening its oversight of the exchanges on which Ontarians and Canadians trade by preventing the TMX from merging with an established foreign exchange. Global exchange markets are becoming increasingly competitive. As technology links different countries even more closely in the future[25], Canadians will have even greater practical choice over where they will execute their trades. If greater liquidity and lower trading costs can be had on foreign exchanges, over time Canadians will gravitate there.

[24] See, e.g., Padilla and Pagano, *supra*.
[25] For example, the TSX has increasingly reached out to foreign traders by improving its communications systems. See, e.g., "TSX agrees low-latency [sic] connection for US, European traders" Sept. 30, 2010, The Trade News, available online at: http://www.thetradenews.com/trading-venues/exchanges/5149 (date accessed: June 21, 2011) (noting that TSX partnered with Hibernia's Global Financial Network which has 24,000 km of submarine fibre-optic cable that allows latency of less than 10 milliseconds from Toronto to Newark/New Jersey. The network also connects Canada to the UK and other European locations).

The parties propose this transaction in order to achieve economies that better position them to face increasingly intense competition between international exchanges. If the Commission blocks the transaction, it would undercut the parties' preferred strategy for succeeding in a globalizing market. While the future is unknowable, it is plausible that if the Commission constrains the TMX from following its chosen path to realize the kind of international scale that will likely be necessary for exchanges in the coming years, the TMX and its exchanges could shrink in importance not just in global, but more relevant for regulatory purposes, in Canadian and Ontarian trading activity. If this happens, then the Commission will have undermined, not preserved, the regulatory status quo by disallowing the present transaction. The business case for the transaction and the regulatory case for allowing the transaction are closely related.

## III. Conclusions

In their materials sent to the Commission and in their Circular to shareholders, LSEG and TMX emphasize two points: first, the transaction would not significantly affect the regulatory authority of the Commission; and second, there is a compelling business case for the merger. I expressed my agreement with the first conclusion in Section I. For a number of reasons, but especially because TMX and TSX would remain subject to direct Commission oversight, I do not believe that this transaction poses any kind of meaningful threat to the regulatory status quo (I have taken the desirability of the status quo as given). Approving the transaction would not pose a significant risk to the Commission's regulatory authority.

In Section II, I linked the regulatory authority of the Commission and the business case for the merger. I reviewed the theory and evidence on the advantages of scale for exchanges.

These advantages support the claimed business case for the merger that the parties present, but more importantly for present purposes, offer some insight into the regulatory implications of disallowing the transaction. If the Commission does not allow the transaction to proceed, and generally prevents Canadian exchanges from integrating with global partners, it creates a threat in the medium to long term to its regulatory reach. TMX proposes this transaction as its preferred means of achieving economies of scale and scope. If the Commission forecloses this strategy, it would undermine the TMX's response to increasing competition in globalizing exchange markets. If this erodes TMX's competitive position over time, as is plausible, Canadians and Ontarians would increasingly opt to trade on foreign exchanges, and blocking the transaction would have resulted in the diminishment of the Commission's regulatory oversight of the exchanges on which Canadians and Ontarians do their trading.

The analyses of Section I and II together present a clear perspective on the decision to allow the merger or not from a regulatory perspective: allowing the transaction poses little risk to the regulatory status quo, while disallowing the transaction would invite greater risks to the status quo in the medium to long run. In my view, the Commission should approve the transaction.

Sincerely,

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