Ivan Mortimer-Schutts and Bob Litan comment on the possible regulatory implications of a Euronext- Deutsche Börse Merger
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Blessing of Britain vital to European exchange watchdog

A merger between Euronext and Deutsche Börse, the Paris-and Frankfurt-based stock exchanges, could finally tip the balance in favour of creating a European Union equivalent of the US's Securities and Exchange Commission in place of national regulators. The benefits of a merger would be greater under a single regulatory framework. But, following the model of the euro, the end result could be a European SEC au noyau dur (for "core" countries), with an opt-out for those that prefer to maintain their own governance structures. If this happened, the UK would face a familiar dilemma: should it stay or should it go?

European financial markets are dominated by three big centres: London, Paris and Frankfurt. Together they represent about two thirds of all European trading volume and value. For cross-border, intra-European business, the concentration in these marketplaces, in particular London, is even higher.

For most investors and intermediaries, it is not efficient to maintain a physical presence in all the European centres. Economies of scale can be exploited by investors from different countries concentrating business in one or two places. In most European countries, professional investors channel 40-75 per cent of their non-domestic intra-European securities business via London.

A Euronext-Deutsche Börse would create a "single" continental market that begins to rival London as a hub for cross-border business. But to benefit fully from the potential economies of scale, regulatory barriers would have to be removed. Differences between supervisory approaches means that Euronext has not yet been able to reap the full benefits of merging its national exchanges – Paris, Amsterdam, Brussels, Lisbon and the Liffe derivatives business. But with the addition of Deutsche Börse there could finally be enough pressure on the respective national – and, in Germany, state level – supervisors to forge one integrated regulatory framework for this major European exchange operator: eventually, a European SEC.

The current concentration of cross-border business in London means the UK's Financial Services Authority is de facto the closest thing Europe has to a "European" regulator. Its staff have a highly international perspective. There are serious doubts, though, about whether the UK would want to be part of a European SEC. And if Nasdaq's bid for the London Stock Exchange succeeded, the temptation for the UK to opt out would be even stronger.

Governments that dislike regulatory competition are the ones most likely to be in favour of a "core European" SEC. But, ironically, regulatory competition is exactly what it might foster. If the UK opted out, a regulator built around core Europe would face potential competition from London. And if the FSA applied a lighter touch and refrained from protectionism, London could win business from continental rivals.

The UK government would be beset by a familiar problem. The City's success is often attributed, at least in part, to good supervision. Ceding powers to a European authority would put that at risk. But staying out would risk loss of influence on the development of European regulation. It might even endanger the ease of access to continental markets that London-based institutions currently enjoy.

For large, established institutions there could be advantages to London opting out as long as an accord were struck that preserved access for UK-based institutions to core Europe. Enough regulatory barriers between member states would remain to shelter big incumbents from any serious competition from new entrants.

But the wider continental public should hope the UK would participate. It would be a force for promoting an open, dynamic market and fighting against "small Europe" economic patriotism. Many European individuals and companies have benefited from the strength of London as a world financial centre – by moving or doing business there. The UK has benefited from this influx of professionals, without whom London firms would be less well placed to compete across Europe.

Although the temptation to opt out would be strong, the UK should, for its own sake and for that of European citizens, opt to take part and seek to ensure that the benefits of a dynamic marketplace are extended to those Europeans who have so far chosen to stay at home.