NORTON ROSE

Sector regulation and competition law in financial services markets

Remarks before the 4th Annual Asian Competition Forum Conference
Hong Kong, 8 December 2008

Marc Waha
Norton Rose

Thank you for the opportunity to participate in today's discussion about sector regulation and competition law in the financial sector. I will be speaking of the tensions that exist between sector regulation and competition law in financial services markets. By "financial services", I mean those services offered by banks and insurance companies to consumers and corporations. I will also address some tensions which exist between competition law and regulation in relation to financial markets. These are the regulated exchanges on which securities are traded.

As I have only around 15 minutes to speak today, I will adopt a broad-brush approach to both financial regulation and competition law. Banks and insurance companies play a vital role in financing trade, investments and sometimes consumer consumption. The banking sector is crucial to an efficient allocation of resources and hence to economic growth. Financial markets enable companies to find sources of capital to support their activities in the long run.

1 Commonalities and tensions

1.1 At the risk of being very general, it appears to me that banking and financial market regulations share a common purpose with competition law: enhancing economic growth and market efficiency, by favouring competition among market players. Banks are encouraged to compete to obtain deposits and extend credit. Financial market regulation fosters effective competition among firms for investments by the general public.

1.2 The student of regulation in the financial sector will however quickly identify some tension with the objectives of competition law. It is my purpose today to identify some of these tensions through a discussion of a couple of precedents. As competition law is still a relatively new phenomenon in this part of the world, I will rely on foreign precedents.

First, while banking regulators acknowledge that competition in the banking sector is generally beneficial, it may, on occasion, "result in bank frauds, unduly risky or illiquid bank loans, overexpansion of bank credit, monetary instability, bank failures and panics."[1] In view of preventing these risks to occur, and because of the role of banks in the economy, regulators have evoked the national interest to assure that banks are regulated in such a way as to promote financial stability.[2] This is a first tension which I will illustrate with a recent merger case in the UK banking sector.

There is a second tension I wish to illustrate today. While both competition law and financial market regulation aim to foster an efficient allocation of resources in the market, financial market regulation is typically designed to create a level-playing field and market transparency in view of protecting investors. Market transparency in particular is a topic where competition and financial market regulators may disagree.

---

1 *The Sec's Evolving Role in Bank Regulation*, address by John R. Evans, SEC Commissioner, to the American Institute of Certified Public Accountants, National Conference on Banking, Washington, D.C., December 12, 1977.
2 *Id.*

2 First example: consolidation in the banking industry, financial stability or competitive markets?

2.1 In 2001, the merger between Lloyds TSB - Abbey National was prohibited by the UK Competition Commission, on the grounds that it would lead to a substantial lessening of competition on retail markets for personal customers and SMEs. The merger would lead to Lloyds TSB having a share of around 27% on the market for personal accounts. The collective share of the big four UK banks would rise from 72 to 77%. The concentrated market structure would facilitate tacit collusion among the big four. Market entry was deemed to be unlikely.

2.2 In September 2008, HBOS and Lloyds TSB announced their merger plans. On 24 October 2008, an amendment to the UK's merger control rules came into effect. It introduced a new public interest consideration to be weighed against public interest consideration of effect on competition: "maintaining the stability of the UK financial system".

On the same day, the UK competition regulator (the OFT) issued a report which stated that "there is a realistic prospect that the anticipated merger will result in a substantial lessening of competition in relation to personal current accounts, banking services for small and medium sized enterprises and mortgages."

The merger would lead to Lloyds having a share of around 33% on the market for personal accounts. The collective share of the big four UK banks would rise from 67 to 80%. The OFT was also concerned by size and behaviour of the combined business post-merger and by the loss of HBOS as a leading challenger to the four established retail banks.

2.3 Under competition law, a merger will typically be allowed to proceed even if it creates competition law restrictions when it is clear that the target is on the verge of collapse. A so-called "failing firm" defence is generally available (1) if the target would be forced out of the market in the near future if not taken over by another firm; (2) if the acquirer is likely to gain the market share after the bankruptcy of the target in any instance; and (3) if there is no less anti-competitive solution. However, in this case the OFT considered that the defence was not available: "it is not realistic to consider that HBOS would have been allowed to fail (or that its assets would have been allowed to exit the market)".[3]

According to the OFT, an alternative solution would pose less threats to competition. For example, HBOS could remain independent with some government support, and then in the longer term either sold to a third party with no competition issues or returned to independent operation.[4]

However, on 31 October the Secretary of State cleared the transaction on financial stability grounds.

3 Second example: market transparency

3.1 Let me now turn to my second example. On a regulated exchange like the Nasdaq, the trading rules and the way the Nasdaq quoting system was initially set up led to relatively broad quoted spreads. In particular:

- the fact that limit orders priced within the best bid and offer usually did not improve the quote;
- the ability of brokers and dealers to agree on preferencing order flow did not provide them with an incentive to offer better quotes;

---

3 OFT, Report to the Secretary of State for Business Enterprise and Regulatory Reform on the anticipated acquisition by Lloyds TSB plc of HBOS plc, 24 October 2008, paragraph 59, page 17.

4 *Idem*, at paragraphs 71-86.

- the fact that dealers could purchase stocks on an interdealer market to execute their orders led to many transactions not affecting the quotes;

- there was also a large number of investors who had managed to negotiate commission fees down; this again did not provide an incentive for brokers and dealers to compete on spreads.

Apart perhaps for the interdealer market, the Nasdaq was very transparent and both investors and market makers would have very easily detected a narrowing of the spread. The Nasdaq rules in effect created market transparency and a level-playing field among investors.

3.2 In 1996, the US Department of Justice held that Nasdaq market makers inflated the quoted spread on certain stocks, resulting in investors having to pay more to buy or sell stocks than they would have in a competitive market.[5]

Buy/sell prices were quoted using 25 cents increments. The practice followed a long-standing "quoting convention" accepted as an industry practice. Market transparency allowed market makers to easily detect any departure from the industry practice.

The case was ultimately settled, amid a controversy over the possibility for more than 60 Nasdaq market makers to maintain and enforce collective practices.

In this case, it is clear that while market transparency was required to establish a level-playing field and ensure that all investors be treated equally, it also allowed firms to signal or tacitly collude on the market.

4 Regulators competing for jurisdiction

4.1 There are countless other cases where common banking industry practice has been challenged under competition law grounds. Membership rules of regulated exchanges have also come under the scrutiny of antitrust regulators. Banks and credit card issuers have faced investigations in many parts of the world in relation to their cooperation on payment systems.

Most of these cases involve, at least to some extent, inconsistencies or outright conflict between sector regulation and competition regulation. From a practical perspective, market players have often faced regulators competing for jurisdiction.

4.2 Regulatory infighting is never beneficial to legal certainty and the development of the economy. For firms active in the financial sector, the tensions we discussed today create significant risks:

- When there is a conflict between competition law and sector regulation, which takes precedence?

- In markets where sector regulators make use of soft regulation, guidance and industry discussions, can market players rely on such guidance as a defence under competition law?

- Is the information provided to the sector regulator available to the competition regulator? Are the two working together towards consistent enforcement?

Resolving these issues should be a priority, especially in relation to the precedence of sector regulation over competition law. In a world where competition law infringements are increasingly becoming criminally sanctioned, market players would benefit from greater certainty.

---

5 *Justice department charges 24 major Nasdaq securities firms with fixing transaction costs for investors*, US DOJ press release, 17 July 1996.

*
*   *

It results from this brief overview that competition law and financial sector regulation are interrelated though they may not always point in the same direction. Ideally competition legislation should make it clear when financial regulations or regulators take precedence; the interplay between self-regulation and competition law could also be clarified. In any event, competition regulators should act together with sector regulators under a framework that obligates this. Uncertainty as to which set of regulations takes precedence, and more generally on what is permitted and what is not in the financial services industry can only result in less effective and efficient financial markets generally.

Marc Waha

Further reading

Consolidation and financial stability in the banking sector

1 *The Sec's Evolving Role in Bank Regulation*, address by John R. Evans, SEC Commissioner, to the American Institute of Certified Public Accountants, National Conference on Banking, Washington, D.C., December 12, 1977.

2 Gregory J. Werden, *Perceptions of the Future of Bank Merger Antitrust: Local Areas Will Remain Relevant Markets*, XIII Fordham J. Corp. & Fin. L. 581 (2008).

3 OFT, Report to the Secretary of State for Business Enterprise and Regulatory Reform on the anticipated acquisition by Lloyds TSB plc of HBOS plc, 24 October 2008.

4 UK Department for Business, Enterprise and Regulatory Reform, *The Creation of a new Public Interest Consideration on Stability of the UK Financial System*, 7 October 2008

Market transparency

5 *Justice department charges 24 major Nasdaq securities firms with fixing transaction costs for investors*, US DOJ press release, 17 July 1996.

6 European Commission, *Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis,* 25 October 2008.

7 European Commission, *Communication regarding a temporary framework for State aid measures to support access to finance in the current financial and economic crisis*, 28 November 2008.

8 European Commission, *Recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition*, 2 December 2008.

Competing for jurisdiction

9 French Council of State, judgment of 16 May 2003 in case No 255482, *Credit Lyonnais*.

NORTON ROSE

Norton Rose Group

Norton Rose Group is a leading international legal practice. We offer a full business law service from offices across Europe, the Middle East and Asia. We are strong in financial institutions, energy and infrastructure, corporate finance, transport and technology and focus our efforts and expertise on these five strategic areas. The Group comprises Norton Rose LLP and its affiliates. Norton Rose Group has over 200 partners, over 1,000 lawyers and 2,000 staff worldwide.

In all these areas, the Group works primarily for international corporates and financial institutions on large, complex, cross border transactions, offering the full range of business legal services. More detailed information on the Norton Rose Group international team is available on the Group's website at: www.nortonrose.com.

Norton Rose in Hong Kong

Norton Rose's Hong Kong office opened in 1976, having a long history in Hong Kong and a strong network of relationships with a range of financial institutions, corporations and other key organisations.

The office's main areas of focus are banking, acquisition and leveraged finance, project finance, corporate finance, dispute resolution and competition. All of our lawyers in Hong Kong have Asian experience and many are both Hong Kong and UK qualified. The Hong Kong team has the resources to lead and manage large, complex transactions, both in the domestic market, mainland China and internationally.

Our competition practice

Our competition team has established a leading reputation in the key European jurisdictions. The group consists of some 40 specialist competition lawyers, covering the major European countries, and since recently, Hong Kong, China and Singapore.

Norton Rose Group set up an Asia competition team based in Hong Kong following the increasing needs of its clients for Asia-based competition advice. As companies become more global, they have to deal with competition issues in various jurisdictions. Norton Rose Group wanted to be able to offer a practice that can provide joined-up global compliance to clients. While the main team is based in Hong Kong, we provide advice across various Asian jurisdictions in addition to Hong Kong. The team currently focuses on advising Asian businesses on global competition law issues, including on M&A transactions, cooperation agreements, dominance issues and cartels. We are also advising foreign companies in dealing with the emerging competition regimes in China and South East Asia. A recent focus in Hong Kong has been to assist major corporates on the possible adoption of a competition law.

The team draws its strength from its in-depth knowledge of the key industrial sectors the Norton Rose Group is renowned for, mainly transport; financial institutions; energy; communications, media and technology. Our Hong Kong-based lawyers are all competition law specialists with overseas experience.

We are one of the few major international legal practices to combine a substantial merger control practice with a significant non-transactional competition practice, including a specialised cartel investigation unit. The competition and regulatory group has wide experience of EC and national competition and regulatory regimes in a wide range of industry sectors.

We offer a complete competition and regulatory service, including: cartel investigations, market investigations, competition litigation, rules on anticompetitive agreements, cartels and abuse of dominance, state aid, public procurement, mergers, acquisitions and joint ventures, utilities and sector regulation and WTO and international trade.

NORTON ROSE

CONTACTS

HONG KONG **Norton Rose Hong Kong** 38/F Jardine House 1 Connaught Place Central Hong Kong SAR Tel: +852 3405 2300 Fax: +852 2523 6399	**SINGAPORE** **Norton Rose (Asia) LLP** One Raffles Quay 31-01 North Tower Singapore 048538 Tel: +65 6223 7311 Fax: +65 6224 5758
BEIJING **Norton Rose LLP** Office C-801, Lufthansa Centre 50 Liangmaqiao Road Chaoyang District Beijing 100125 People's Republic of China Tel: +86 10 8448 8881 Fax: +86 10 8448 6220	**BANGKOK** **Norton Rose (Thailand) Limited** Floor 14, Tower 2, Sindhorn Building 130-132 Wireless Road Bangkok 10330 Thailand Tel: +662 263 2811 Fax: +662 256 6703/5
SHANGHAI **Norton Rose LLP** 27/F, Plaza 66 II 1366 Nanjing Road West Jing An District Shanghai 200040 People's Republic of China Tel: +86 21 6137 7000 Fax: +86 21 6137 7088	