

Controlling entry and platform fees best way to control market power

February 19 2019

Technological services can be strategic substitutes or complements in platform competition, new research from Cass Business School has found. The researchers found that platform free entry delivers a superior outcome in terms of liquidity and welfare compared to the case of an unregulated monopoly. However, this does not necessarily match the regulator's preferred outcome, as entering platforms fail to internalise the externalities they impose on traders and rivals. The authors recommend that controlling entry or—preferably—platform fees may serve as an instrument to further increase investors' welfare.

The research comes at a pertinent time, following the news that some of Wall Street's biggest brokers and banks have backed a new stock exchange—Members Exchange (MEMX) - that aims to break the dominance of the New York Stock Exchange and Nasdaq by reducing trading costs.

In Exchange Competition, Entry, and Welfare, the researchers merged a two-period market microstructure model with an exchange competition model with entry in which exchanges supply technological services, to analyse the [welfare](#) effects of different entry regimes.

Paper co-author Professor Giovanni Cespa said this approach recognises that the market structure enabling traders' interaction is the result of a game among three parties: market participants (dealers and traders), trading platforms, and the regulator.

"Platforms produce technological services, pricing them at a mark-up whose magnitude depends on the competitive pressure they face from rivals. Dealers purchase technological services from platforms, and use them to accommodate trading needs. In this situation, market [liquidity](#) is higher, the number of dealers adopting the technology offered by market platforms is larger, which, in turn, depends on the magnitude of platforms' markup. A higher liquidity, in turn, lowers transactions costs and is therefore beneficial to market participants' welfare," he said.

The researchers found that the unregulated monopoly solution yields the worst possible outcome, both in terms of liquidity and welfare, with the monopolist charging the highest possible markup, which implies the lowest possible level of technological service adoption, leading to low liquidity and welfare.

By contrast, when platforms freely enter at the point at which they make enough to recoup set-up costs, it is better in terms of liquidity and welfare. However, such an outcome does not necessarily match the regulator's preferred outcome because each platform's entry decision fails to internalise the externalities it imposes on rivals and traders.

"In fact, heightened competition lowers the industry mark-up, compressing exchanges' profits and yielding a negative profitability depression effect. At the same time, as a lower markup favors technology adoption, increased entry improves liquidity, benefitting traders' welfare, and leading to a positive liquidity creation effect," Professor Cespa said.

In a merger policy framework, the regulator chooses the number of platforms that maximises total welfare, ensuring that no platform incurs a loss. Thus, free-entry always tends to be excessive, as the regulator internalises the profitability depression effect. Conversely, if besides controlling entry the regulator is able to subsidise platforms for their

contribution to liquidity provision services, entry can be excessive or insufficient, depending on the relative strength of the induced externalities.

Professor Cespa said merger policy is only one of the possible instruments a regulator can adopt and the paper also analyses the welfare benchmark implied by technological fee controls.

The researchers found that when a regulator sets a fee low enough to make it profitable for only one platform to enter the market, such a regulated monopoly outcome allows savings on the set-up costs, and this tends to be better than any of the outcomes achieved by competitive interaction—both regulated and unregulated.

"Viewed through the lenses of our model, this puts in perspective the recent complaints of market participants who have asked for stricter regulatory oversight over US exchanges' technological services pricing decisions," he said.

Professor Cespa said the research suggests that exchanges' technological capacity decisions can be an important driver of market liquidity, adding to the usual, demand-based factors highlighted by the market microstructure literature (e.g., arbitrage capital and risk bearing capacity of the market).

"Viewing liquidity determination in a model where [market structure](#) is determined by market forces opens up a number of interesting implications. For example, we found that when dealers become more risk averse, they tend to put a higher value on technological services. This implies that their demand for platforms' technology can increase, with a positive effect on market liquidity.

"This serves as a warning against the common view that sees regulatory

provisions that make it costlier for banks to provide liquidity, as liquidity reducing. It also provides a potential explanation for the contrasting empirical findings of post-crisis regulations aimed at reducing investment banks' trading activities."

Provided by City University London

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