New regulations drive development of global markets

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Created *17/01/2008 - 13:32*

Compliance is not normally a word that quickens the pulse. But this year's introduction of new US and European regulations on stock trading has strengthened an existing trend towards consolidation, product diversification and international expansion among securities exchanges.

Regulation National Market System (Reg NMS), introduced in the US in March and the European Union's Markets in Financial Instruments Directive (Mifid), launched in November, both seek to liberalise equities trading with new requirements on best execution. Combined with technological developments in electronic trading, the new rules are breaking the incumbent exchanges' stranglehold over share transactions.

Reg NMS requires an equity exchange to demonstrate that it has done everything possible to prevent 'trade-throughs' - the execution of an order in its market at a price that is worse than a price available in another market. This requirement clearly favours electronic over traditional open outcry trading, and has allowed start-ups to challenge the dominance of NYSE Euronext and Nasdaq. The most successful newcomer has been Bats Trading, a high-speed low-cost platform based in Kansas, which was only established in 2005, but has captured 10 per cent of Nasdaq-listed stock transactions.

Bats' arrival has sparked a fierce price war. NYSE responded to market share losses by cutting prices in September on its Archipelago electronic platform, which it runs alongside its floor-based specialist system. Bats, too, unveiled fresh price incentives for the fourth quarter. Unsurprisingly, margins are under pressure. According to Celent, a consultancy, margins at US exchanges are only 8 or 9 per cent. Margin compression places greater emphasis on the need for a low-cost structure and suggests that the days of NYSE's traditional floor are numbered - despite the exchange's protestations to the contrary. Fierce competition is also likely to lead to greater concentration among smaller electronic platforms.

Competition has also spurred stock exchanges to diversify into derivatives and to look overseas for growth opportunities. For example, following the completion of the NYSE's merger with Euronext this April, derivatives now account for 25 per cent of net revenues of the enlarged group. The traffic is not all one way across the Atlantic. Deutsche Börse, which operates the Frankfurt Stock Exchange, has expanded into US derivatives with the acquisition of the International Securities Exchange through the Eurex derivatives exchange, in which it holds a majority stake alongside junior partner SWX Swiss Exchange.

As the stock exchanges encroach on their turf, the incumbent US derivatives exchanges have also consolidated, with the completion this summer of the merger between the CME and the CBOT. With the ink barely dry on the deal, the enlarged CME group has expanded overseas, buying a stake in Brazil's Mercantile and Futures Exchange and adding Korean stock futures to its platform. NYSE Euronext is also eyeing Latin America, and has acquired a small stake in Brazil's Bovespa. The new breed of exchange will increasingly offer cross-border trading.

Nasdaq, meanwhile, after being stymied in its attempts to buy the London Stock Exchange, in September struck a complicated deal to take control of OMX, the Nordic exchanges group. Nasdaq was effectively allowed a free run at OMX by bid rival Borse Dubai, which in exchange acquired a 28 per cent stake in the LSE from Nasdaq. Borse Dubai will also hold a fifth of the combined Nasdaq/OMX group, while the American exchange will take about a third of DIFX, Dubai's international exchange. As well as setting a new benchmark for complexity, the deal puts the Gulf States on the map in the international expansion of securities trading.

Nasdaq's retreat from its assault on the LSE was in part driven by the latter's own overseas expansion. The LSE's all-share acquisition of Borsa Italiana both diluted Nasdaq's stake and gave the

London exchange exposure to bonds and derivatives. For the time being, it appears that the LSE will remain independent post-Mifid, albeit facing a more competitive environment.

Mifid removes the requirement that brokers put all trades through the local exchange, ending a monopoly on share trading on some exchanges in France and Spain.

Chi-X, a trading platform owned by Instinet Europe, was launched ahead of Mifid's introduction and is a guide to likely future competition. Offering faster, lower cost trading in markets not bound by the local exchange rule, Chi-X has taken market share from the Dutch and German exchanges.

Best execution under Mifid includes not only price, but also speed and certainty of execution. Technology has taken centre-stage, prompting investment in smart order-routing systems that search out the best available price across trading venues. One probable consequence will be greater concentration on the sell side, as larger banks will be able to spread the costs of compliance and new technology over larger traded volumes. With margins on some European exchanges still in excess of 50 per cent, it is difficult to avoid the conclusion that the US price war will be repeated in Europe.

The new rules also allow the creation of multilateral trading facilities - electronic trading platforms similar to the US crossing networks - and permits banks to become 'systematic internalisers', matching orders without going through an exchange. The race is on between banks and exchanges to capture this 'dark liquidity'.

NYSE Euronext has formed an alliance with HSBC and BNP Paribas to create Project Smartpool by the middle of 2008, which will trade large blocks of shares away from the public market. Meanwhile, seven of Europe's largest investment banks have formed Project Turquoise to create a rival electronic trading platform, which will include a dark liquidity capability. Scheduled for an autumn 2008 launch, Turquoise is running behind schedule following delays in announcing a chief executive and a technology supplier.

Nonetheless, established exchanges are taking the threat seriously. The LSE, for example, this year installed TradElect, a high-speed platform that has reduced the time taken to execute a trade to six milliseconds. The LSE is also offering incentives for banks to put trades through the exchange rather than match them internally.

After a year of frenetic activity there is little sign that the consolidation and expansion trends are complete. The building of small stakes in emerging market exchanges by the industry's large players suggests that the next battlefields will be in Asia and Latin America, where traded volumes are growing fastest.

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