Consolidation hands more power to end-consumers

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Betting on consolidation among listed exchanges has been a profitable strategy for event driven hedge funds. But will the more competitive environment driving that consolidation trend be good for hedge funds as end consumers? Clara Furse thinks it may not. The London Stock Exchange's chief executive believes that increased competition in equities trading following implementation of the Markets in Financial Instruments Directive will lead to fragmented markets and wider bid/ask spreads.

Initial indications, however, suggest that Furse's concerns may be unfounded. The launch this year, for example, of Instinet Europe's Chi-X electronic trading platform, which offers trading in the component stocks of the FTSE 100, CAC 40, AEX 25 and DAX 30 indices, has led to narrower rather than wider spreads.

Based on Chi-X's own data for the six months to the end of October, at least half of the trades executed each month have been completed inside the price spread available on the primary exchanges, with an average price improvement of two basis points. Volume, unsurprisingly, is growing rapidly - on some days Chi-X has captured as much as one fifth of the traded volume in large shares such as Royal Dutch Shell and Philips.

Chi-X's traditional competitors do not intend to relinquish their dominant position without a fight. NYSE Euronext, for example, has claimed that the reason for narrower spreads on Chi-X has been the platform's ability to quote prices to three decimal places, compared with two decimal places on Euronext Amsterdam. In January, Euronext will raise the bar and offer trading to four decimal places. Furthermore, with the exchanges' largest customers actively setting up their own electronic platforms, such as Project Smartpool and Project Turquoise, downward pressure on trading spreads looks set to continue.

Trading costs, as well as spreads, should fall in Europe if US experience this year after the introduction of Regulation National Market System is any guide. The success of new entrant Bats Trading in taking market share from Nasdaq and NYSE Euronext in US equities has sparked a price war among the US exchanges. In February Bats extended the range of its product offering to include NYSE-listed stocks, forcing the New York exchange to play catch-up and cut its own tariffs in September.

The pressure, however, is still on. Most US exchanges use a charging structure in which investors posting firm bids/offers (posting liquidity) are given a rebate on the tariff they pay to buy/sell shares (lifting liquidity). Bats has unveiled further price cuts for the fourth quarter of 2007, which effectively allow customers who lift and post liquidity in equal measure to trade without cost. The Kansas City-based platform claims that cutting its prices for a short time has been successful in producing a lasting increase in market share.

Nasdaq, meanwhile, has admitted that its own share of trading in NYSE-listed stocks fell - at least temporarily - in response to Bats' price cuts. While the intensity of the current war may not be sustainable, customers are happy, and have the technology, to seek out the cheapest quotes.

For hedge funds, price is not the only consideration. Speed is of the essence, particularly for funds using algorithmic trading programmes. Fortunately for the end user, the competition to reduce latency - the time between sending an order and completing it - is becoming as fierce as the competition on tariff structures. The London exchange, for example, rolled out its high-speed platform TradElect in June this year and has already unveiled an updated version with a further 30-40 per cent reduction in latency to six milliseconds per round trip. Chi-X, meanwhile, claims an average latency of just two milliseconds, which it says is 10 times faster than what is on offer at the traditional European exchanges.

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Hedge funds can also expect this year's new regulations to help reduce 'market impact' - the adverse price movement while an order is being completed. The definition of best execution under Mifid includes certainty of execution, and removes the obligation still present in some markets to channel all orders through local exchanges. The matching of customer orders internally by banks and brokers is already a feature of the market - the Tabb Group, a consultancy, this summer estimated that it accounts for 10 per cent of US share trading.

But the importance of this off-market activity is set to increase as new market entrants, such as Project Turquoise, include functionality to capture off-exchange 'dark liquidity'. Algorithmic trading programmes have allowed hedge funds to split large orders into small, easily executed pieces to minimise market impact. Matching orders without going through the market produces extends the advantages of low impact to far larger trade sizes.

Competition for pools of dark liquidity is one aspect of an emerging trend in which investment banks and exchanges are no longer just each other's customers, but instead also compete for hedge funds' business. Hedge funds for their part - some motivated by a belief that investment banks trade on the back of their ideas, thereby increasing market impact - are also pressing to cut out the middleman.

MTS, the European government bond trading platform, for example, is considering a request by a group of hedge funds, including Citadel and DE Shaw, for direct access. Eurex, the futures exchange, and SWX Group, the Swiss exchange, allow direct membership by hedge funds. In addition to developing their own electronic exchanges, investment banks have been forced to invest in direct market access 'black box' programmes - which earn very low commissions - in an effort to retain algorithmic trading business.

New regulation and improved trading technology have shifted the balance of power between investment banks, securities exchanges and hedge funds in the latter's favour. Fortunately, the securities industry is not facing a zero-sum game. Competition may be increasing but trading volumes are growing rapidly - particularly in Asia - and the return of market volatility this summer has spurred more, not less, activity in exchange traded products. As end-consumers, hedge funds can expect part of these economies of scale to continue to be passed on.

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