Decentralisation of trading creates attracts host of new players

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A year is a long time in financial markets. Aside from the credit crisis making the transition to a fully-fledged economic downturn, it was a year in which Mifid started to work its magic and trading in Europe began - at last - to decentralise. A whole new crop of platforms, or MTFs (Multilateral Trading Facilities), materialised from the ether to take on the might of the incumbent stock exchanges.

There are now close to a dozen MTFs and their number seem to be swelling month by month. They each claim to offer something unique in the market, with lower costs, faster transactions and reduced implementation shortfall among the main selling points.

Chi-X Europe, for one, which launched in March 2007 and is now the fourth-largest European exchange in the 750 stocks it offers, has already gained traction in the market. Figures from August show it handled 7,319,096 trades, more even than Deutsche Borse, which handled 6,623,281 trades. This is still well behind the 12,000,000 plus trades of Euronext and LSE, but indicates that the incumbents are facing genuine competition. 'There was a level of dissatisfaction with the previous regime,' says Peter Randall, chief executive of Chi-X Europe, 'but the lack of competition meant investment banks just had to keep paying.'

Indeed, cost is widely perceived as the Achilles heel of the major exchanges. Randall says: 'The challenge for incumbents is that Chi-X has 27 staff and operates out of modest offices outside the City of London while the LSE has a staff of 1,100.' However, he concedes that some LSE staff are involved in other types of activity than pure trading. Meanwhile, Euronext employs 5,000 people and Deutsche Borse has 3,000.

And MTFs have more in their armoury than low operating costs to make trading cheaper for users. Many employ the maker-taker model, which offers rebates to users who offer liquidity. 'That means, for the first time, the trading community is rewarded for posting liquidity,' says Randall. 'At the heart of this rebate pricing model is a lean margin for us of just 0.1bp. Or, put another way, for every million shares traded, we earn E10. This is particularly attractive for high volume participants.'

But Frederic Ponzo, managing director of NET2S, a consultancy, points out that the cost of trading is not everything. 'The bulk of the cost of a transaction is in the back office. Lower costs are less important overall than getting an order filled quickly and fully,' he says.

The big question now - 18 months after the first new platform was launched - is can MTFs win sufficient market share to justify their existence? Well, according to a study by Tabb Group, a US-based consultancy, the new entrants will win 21 per cent of market share over the next three years before consolidation occurs.

Chi-X, the European pioneer, says it has already broken even and is better positioned for a downturn than the incumbent exchanges. Says Randall: 'We have a strong balance sheet to weather a period of extended slow markets for 18 months or more. With share prices down across the board, the imperative for investors to pay lower costs will be all the greater and this plays to our strengths.'

So far, Chi-X has achieved its launch targets. Last April, it said it wanted to go above the 25 per cent level in FTSE 100 trading within a year, and take more than 15 per cent of volumes in the CAC 40, AEX 25 and the Dax 30. It achieved that by the end of the summer.

So despite the increased complexity caused by fragmentation in the market, investors appear to be warming to MTFs. Phil Allison, head of client trading and execution at Chi-X, says: 'Last August, clients would have been cautious but they have seen how it is working and are more positive. They want us to be more active.'

Others have yet to be convinced. Richard Muckle, COO of Blue Oar Asset Management, a new company which runs two equity-based funds, says: 'Although we take an active interest in the new trading systems such as Turquoise and Chi-X, we feel it would be too early for us to use them before seeing how larger funds with greater volume fare. For newer operations, the best course of action is to observe from a safe distance until you're sure that teething problems have been ironed out.'

This is music to the ears of incumbent exchanges. They are keen to exploit any initial uncertainty over the MTF model and are fighting back hard. NYSE Euronext, for example, has launched a 'global incentive programme', rewarding traders for using more than one of the group's trading platforms. The scheme is aimed at high-frequency traders - such as hedge funds, asset managers and banks. Similarly, Nasdaq OMX says it will offer users of its new pan-European equities trading facility fee discounts if they also trade on Nasdaq in the US or on OMX, the group's Swedish equities platform. And the LSE has unveiled a radical shift in its fee structure to attract algorithmic traders. However, Chi-X is sceptical about the LSE's move. Randall says the net effect for traders will be neutral because the LSE is putting its prices up in other areas. 'Its three largest customers will get lower fees and that's about it,' says Randall.

Crucially, the incumbent exchanges have a strangle-hold over market data. The LSE, for example, is the only 'reference market' in the UK for pricing purposes. The Investment Management Association, the trade body for UK fund managers, warned in June that investors were unable to judge whether UK equity trades were being executed at the best price, blaming the proliferation of price-reporting mechanisms. The issue was highlighted last month when the LSE's trading system failed. Ponzo says: 'The MTFs gloated and said the technology was not up to scratch. But there was almost no trading on Chi-X and Turquoise because LSE prices are still used to calculate NAV. Without reference prices, everything else is meaningless. This will take years to change.'

Chi-X, Turquoise and Nasdaq OMX have in recent weeks joined an informal working group formed by Plus Markets, a London-based exchange, to help tackle this issue. Bob Greifeld, Nasdaq OMX chief executive, says: 'We certainly want to take a leadership role on that. We think it will not be too difficult to come up with a market-based solution.'

But it's a long road for the MTFs to travel to compete with incumbent exchanges. Each MTF will also need to differentiate itself from its peers as the battle for market share intensifies. 'In a bid to differentiate their products, the MTFs will invest in new matching functions, targeting different audiences and offering a variety of business models, technologies and pricing models,' Tabb says.

Certainly, anyone coming into the market now must have distinct edge. Ponzo says: 'They need something much more than a technical gimmick or gadgetry.' He judges that Chi-X has first-mover advantage, while Turquoise has critical mass because of its investment bank backers. Meanwhile, Equiduct has a smart half-exchange, half-aggregator model and BATs, the latest MTF to go live, is the Walmart of order matching. It is far from clear, though, which one or ones will win out. Ponzo says: 'Like gravity, the bigger you are, the more liquidity you attract. No single ECN has yet to pull away from the rest.'

And no single MTF is likely to kick down the final straight until it is clear that technology solutions can keep pace with the new marketplace. For instance, the use of algorithms, which are increasingly important for fast and efficient trading, has been complicated by the advent of the MTFs.

Simon Nathanson, chief executive of Neonet, says traders need to know they can reach all the venues, - or at least the relevant venues - get the necessary market data and be able to process it. 'Direct market access, viewed in the last couple of years as a commodity, could now be a complex and niche service where issues such as the speed at which orders are executed, becomes a key issue.'

The difficulties are likely to intensify in the future, says Nathanson. 'Next year we may see 30, 40 or even 50 new execution venues if you count MTFs, dark pools and systematic internalisers. It will be too expensive for everyone to build connectivity to all those places and this presents opportunities for providers like us.' However, as in the US with the Electronic Communication Networks (ECNs), consolidation is likely to take place. 'The traditional exchanges eventually bought up many of the ECNs and this is likely to happen to the MTFs in Europe,' Nathanson says.

But, before this happens, MTFs are likely to bring huge changes to the marketplace. Latency for instance, is improving fast and attracting innovative approaches. Nathanson says: 'Thirty years ago, everyone traded together at an exchange. Then with electronic trading they all went back to their own offices to trade. Now, speed of light down cables is the key, so servers need to be close to the order book machine. So you end up with servers instead of people inside the exchange buildings. You could say we have come full circle.'

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