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The latest research by Greenwich Associates into North American and European usage of equity derivatives reveals that these products have moved into mainstream, commonplace usage by institutions on both sides of the Atlantic.

European institutional investors and banks that long ago embraced the lucrative business of selling structured equity derivatives products into the retail market are now integrating equity derivatives into their own investment strategies as an efficient means of obtaining desired exposures.

The results of Greenwich Associates’ 2007 European Equity Derivatives Investors Study reveal large increases in the number of European institutions and banks using equity derivatives, the number of derivatives products used by individual institutions and banks, and the volume of trades executed in these products each year.

“While banks remain heavy users of the structured derivative products they on-sell to their high net worth and retail clients, money managers and hedge funds have adopted options and other highly liquid derivative products as ‘access products’ with which to create virtual positions in some securities or markets that are outside their specific mandates,” says Greenwich Associates consultant Jay Bennett.

Of the 201 European institutions and banks participating in Greenwich Associates’ 2007 study, nearly 80 per cent use
structured/securitised equity products or exotic OTC products, and almost 90 per cent use highly liquid ‘flow’ equity derivatives products such as listed options, index futures, swaps, and exchange-traded funds.

In the 12-month period covered in the research, notional trading in structured/securitised equity products rose by more than two-thirds to an estimated USD230bn across the entire universe of 258 accounts, with 86 per cent of that total originating in continental Europe.

The amount of commissions paid by participating institutions and banks on options trades rose to an estimated USD465m as well. “European institutions and banks are probably the world’s most evolved users of equity derivatives, particularly on the structured side,” says Greenwich consultant John Colon.

The on-selling of structured equity derivatives has become an increasingly important revenue stream for both banks and investment managers in recent years, with approximately 75 per cent of participants in each category reporting that they engage in the business. More than 45 per cent of European institutions and banks say they purchase these products with the intent of on-selling rather than holding them in their portfolios; another 15 per cent say they on-sell some products while holding others.

The most active re-sellers of structured equity derivatives products are found in France, Germany, Spain, and the Nordic countries, followed by Switzerland and the Benelux countries, with UK institutions and banks on-selling the smallest percentages of their holdings.

“There’s a huge and profitable business selling products with all sorts of nuances: they can feature anything from hedge fund-linked returns to oil and gas plays,” Bennett says.

Eighty percent of European institutions and banks now trade single-stock options, up from 75 per cent a year ago, with three-quarters of volume in listed options deriving from UK and continental European underlying assets. The usage of other highly liquid ‘flow’ products is also on the rise. The use of index futures increased modestly to 78 per cent of study participants in 2007, and 33 per cent of institutions and banks now use single-stock futures, up from 25 per cent.

Use of variance swaps on indices and single stocks doubled to 19 and 15 per cent, respectively, with hedge funds and French institutions and banks reporting the highest levels of use. While use of single-stock and index swaps declined slightly to 31 per cent, the notional amount of equity swaps traded by institutions and banks participating in the Greenwich Associates’ study rose 15 per cent over the past 12 months, to an estimated USD85bn.

Last year Greenwich research revealed a surprising, and on the surface at least, counterintuitive finding: institutions in Europe and North America continue by far to favour ‘high-touch’ broker execution for futures and options rather than electronic trading platforms. Three quarters of all options trades and more than two thirds of futures trades in Europe are still communicated to brokers via the old-fashioned telephone.

Bennett attributes the reliance on traditional high-touch trades to the growing use of an increasingly sophisticated slate of equity derivatives products as well as the size of trades. “Due to the volatile nature of derivatives trades, institutions and banks do not want to trust their positions to electronic systems, they want somebody to take over the position as quickly as possible,” he says.

North American equity derivatives: specialised products become commonplace tools

Once regarded as specialised tools, equity derivatives today are used by North American institutions as a routine method of obtaining desired exposures and hedging positions.

The results of Greenwich Associates’ 2007 North American Equity Derivatives Research Study, which targeted more than 200 active investors in the US and Canada, reveal that it is becoming common practice at North American institutions for cash portfolio managers to work in conjunction with traders and equity derivatives specialists to achieve investment goals.

As equity derivatives move into the mainstream, the use of liquid ‘flow’ products like options, futures and exchange-traded funds has become ubiquitous among US institutions. In addition, the universe of equity derivatives investors is expanding as a
growing number of hedge funds enter the market. In 2007, Greenwich Associates interviewed 80 hedge funds.

“The ‘flow’ or highly liquid equity derivatives business is surging,” Bennett says. “Last year, the institutions targeted in our research generated an estimated USD420m of commissions for brokers on options trades – over the past 12 months that amount jumped to an estimated USD775m.”

Although the use of structured/securitised equity products is much less common among North American institutions, it too is on the rise. Forty-two percent of study participants in 2007 say they use structured equity derivatives, up from 34 per cent in 2006. The institutions targeted in the Greenwich Associates study traded an estimated USD35bn notional in structured/securitised equity products in the 12 months covered in the research. More than three quarters of these institutions use single-stock or basket-based products, and about 40 per cent use index-linked products. Smaller proportions use hedge fund and mutual fund-linked contracts.

“The structured equity derivatives business continues to boom in Europe because of strong demand from high net worth and retail investors who purchase these products from banks and other institutions,” Colon says. “That demand does not exist in North America, so the business is growing at a much slower pace.”

Institutional investors are increasingly relying on their cash portfolio managers and traders to make decisions on equity derivatives trades. The proportion of North American institutions saying that decisions regarding equity derivatives are the exclusive province of derivatives specialists fell to 21 per cent in 2007. “Futures and options have become standard tools such as 120/20 and 130/30 investment strategies – we expect equity derivatives use to continue its rapid rise,” Colon says.

Nearly 85 per cent of North American institutions trade single-stock options, up from 81% last year, while nearly 80 per cent trade index options, up from 74 per cent. Hedge funds remain the most active users at 93 and 86 per cent, respectively.

The Greenwich Associates report documents the following additional trends in product usage:

- The use of futures fell from 65 per cent in 2006 to 61 per cent in 2007. Just more than half of the hedge funds participating in the research describe themselves as active users of futures.
- Institutional use of exchange-traded funds slipped from 70 per cent in 2006 to 65 per cent in 2007. Although hedge funds are the market’s most active users of ETFs, the share of hedge funds reporting use dropped to 71 per cent from 81 per cent year-to-year. Conversely, use of ETFs increased sharply among mutual funds.
- Use of single-stock or index-equity swaps decreased from 38 per cent of study participants in 2006 to 33 per cent, reversing a trend observed last year.
- Nearly a quarter of institutions say they use variance swaps, up from less than 20 per cent in 2006. Between 14 and 20 per cent of institutions report using dividend swaps, dispersion/correlation trades, sector swaps, portfolio swaps, and access products. Hedge funds drive activity in most of these categories.
- On the structured equity product side, 54 per cent of institutions that use these instruments said they were active in products with less than one year’s duration, while only 5 per cent were active in products with duration greater than five years.
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The past few years have seen a substantial increase in programme trading on exchanges and an increase in the role played by high-frequency algorithmic traders. Today, an estimated 50 per cent of turnover in some Eurex flagship products is driven by automated trading including hedge funds, and overall more than 30 per cent of volume across all products is attributed to these automated trading systems. For exchanges and users alike, these developments represent both a challenge and an opportunity.

The emergence of sophisticated trading strategies is driving substantial year-on-year growth in order volumes that in turn spurs demand for additional market and price data. Exchanges and their members are faced with the challenge of ensuring that their IT systems and networks are capable of accommodating future demand.

Eurex has responded with regular tuning and upgrading of its IT systems at increasingly frequent intervals. Together with its member base, the exchange has drawn up a Technology Roadmap, launched in January 2006, to co-ordinate the roll-out of a range of measures designed to continue to meet the needs of both buy-side and sell-side customers. These measures include the optimisation of software and implementation of state-of-the-art hardware, such as the introduction of Itanium processors in January 2007.

The exchange has set ambitious targets to ensure that it stays ahead of market demand. By 2009, it aims to raise quote transaction capability to 1.6 billion per day, an almost eightfold increase within three years, and to increase the number of order book updates per second to 2,500 (currently 150) for futures and 10,000 (currently 4,000) for options. The plan also encompasses technology to facilitate the introduction of new products and to ensure that the system can accommodate an annual 25 per cent increase in the number of traded contracts.

The Roadmap plan has a dual focus on both improvements in throughput and functionality. The increase in system capacity will deliver an optimised performance for the response times of order and quote transactions, especially at peak times, and faster dissemination of data. In November 2007, Eurex Release 10 implemented risk monitoring and market surveillance systems to protect clearing firms and ensure the conformity of trading systems to market rules. In addition, new access solutions were made available to meet different member requirements.

The Enhanced Broadcast Solution is an optional innovative high-performance broadcast solution for the dissemination of un-netted public market data. A socket-based data distribution mechanism, its capabilities include the provision of an order book depth of 10 for options (previously only inside market data was provided) and 20 for benchmark futures. These parameters can be varied according to user requirements. In addition, a new subscription model allows members to select individual market data for all product groups relevant for their business.

In April 2008, Eurex will launch an additional optional interface known as the Enhanced Transaction Solution, enabling order and quote transactions to be sent to Eurex. The new interface is message-based and thus provides faster, streamlined access to the Eurex trading system for high-frequency trading strategies.

Eurex has already improved its system and its capacity considerably in order to enable it to handle additional order flow and transactions rapidly. The Technology Roadmap requires continual investment in terms of both financial and human resources. However, the exchange’s commitment to meeting the needs of a customer base that is globally active entails a continuing focus on the market’s requirements not just now but into the future.
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.

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.
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
Indexed investment unlocks Africa

By Nicolas Clavel

Amid the clamour of international investors for access to emerging markets such as Latin America, India and China over the past couple of years, Africa – South Africa excepted – has largely passed below their radar. In part this is down to difficulties in accessing many African markets and the liquidity issues that affect trading in the shares of all but a handful of the biggest companies.

The difficulties in finding reliable brokers in some markets and trading costs that range from 0.5 per cent in the most competitive market, South Africa, to 4 per cent in Zimbabwe can make it difficult to pursue a cost-effective active trading strategy. That’s why when Scipion Capital decided to offer private and institutional investors access to the continent’s largest and most liquid companies, it started with an index tracker fund.

The underlying basis of the Scipion African Opportunities Fund is Africa Investor’s Ai40 index, which limits the number of constituents from bigger countries such as South Africa and Egypt to offer better regional diversification. Requirements for index membership include a minimum capitalisation of at least USD100m, a cap of seven companies per country, a free float exceeding 25 per cent and daily liquidity averaging at least USD100,000 over any 90-day period.

The Scipion African Opportunities Fund, the first and still the only investible index tracker covering Africa, currently offers access to eight markets: South Africa, Mauritius, Kenya, Nigeria, Abidjan (covering the French-speaking countries of West Africa), Morocco, Tunisia and Egypt. The fund replicates the Ai40 index and invests in its 40 constituents.

The index constituents are the continent’s blue chips, many well known outside Africa, such Moroccan cement producer Lafarge Maroc from Morocco, and come from a broad range of sectors, including mining, brewing, telecoms and banking. The total market capitalisation of the Ai40 companies is USD260bn; three-quarters of index constituents have a market capitalisation exceeding USD1bn and the smallest is around USD200m.

As of December 7, the Ai40 index was up by 88.26 per cent since its launch at the beginning of 2006, and had gained 60.97 per cent so far in 2007. The fund itself produced returns exceeding 5 per cent in both September and October, and was flat in November while its main benchmarks, MSCI BRIC and MSCI EM, each fell by more than 6 per cent.

The pan-African market is not yet suitable for an exchange-traded fund because of technical and infrastructure limitations. With no derivatives market outside South Africa and to some extent Egypt, investing in the index requires purchasing the underlying stocks and finding brokers and custodians covering the various markets. The Scipion African Opportunities Fund uses three custodians in Mauritius, Geneva and Dakar.

While waiting for African stock markets to develop, Scipion Capital is launching two related index funds, including an Ai40 ex-South Africa fund aimed at investors that already have exposure to the country. The other, aimed at socially responsible investors, will repay dividends earned by the fund to the companies that paid them, to be used by their own social responsibility departments to carry out social development programmes in their local communities.

Quoted African companies outside South Africa tend to fund expansion by raising bank debt. Increased international interest in African stock markets may change that and encourage locally-quoted companies to raise equity instead, improving the liquidity of the market and attracting a broader range of investors to the continent.
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.