

The death of the exchange



Written by Andrew Simpson

MiFID has finally got underway, and even if you only pay scant attention to the financial media you will probably have noticed an increasing number of MiFID related articles – every day for the week of 1 Nov there was a page dedicated to MiFID in the Financial Times and in the weeks before numerous news alerts on the subject from other sources.

Consistently, these media cover the new venues that are positioning themselves for a liquidity land-grab – the likes of Turquoise, Chi-x, Plus Markets, OMX and Equiduct – and the clear increase in competition that is already apparent. Yet in the face of this increased reporting many people are still questioning whether MiFID will actually really change anything. In our view, we have seen only the start of things to come and the upcoming 18 months are shaping up to be extremely interesting: the trading landscape is only just beginning to show signs of the new competitive arena it will become.

Caution is needed in using such hyperbole, as nothing is certain in the capital markets. We have seen how, over the years, the doomsayers who predicted chaos in the wake of Year 2000 quickly re-positioned their statements to say that it was their warnings that resulted in the successful delivery of that change.

While some in the industry are forecasting the mass migration of capital against a background of regulatory quagmire, this article is not going to attempt such

crystal ball-gazing. In the short amount of available space, the intention is simply to highlight what is already going on and outline a few of the current dynamics to allow readers to measure for themselves the significance of the change we are witnessing and form an opinion of what the market may well look like in the next two years.

This brings us to “the death of the exchange”. First, as we all know, there are many exchanges, although a common colloquialism is to use the phrase The Exchange to mean the London Stock Exchange (LSE), so it is important that the statement should not be misinterpreted to mean the end of this fine institution.

Over the last few months the LSE has looked anything like it was going out of business and in saying that, we find an important introduction to the reason the exchange is dead. In defending itself from the Nasdaq (and other) hostile takeover bids, the LSE has had to change: over the last 18 months it has had to throw off its rather dour, lethargic – even somewhat arrogant – national Recognised Investment Exchange (RIE) image to become an agile, competitive force. This has resulted in a share price increase of about 30% (£12.50 to £16.25) in the last six months. Moreover, it has demonstrated tremendous awareness of its competitive position, launching new products to proactively respond to MiFID. So, by talking of the death of the exchange we certainly do not imply any negative

connotation for The Exchange but, rather, indicates we should adjust our frame of reference for what an exchange once did.

If you search through the MiFID text, you will find that “exchange” is used as a noun only once: in Level 1, Recital (57), and almost immediately in the following sentence the phrase “Regulated Market” takes its place. Elsewhere ‘exchange’ is used as a verb.

This tells a very interesting story: that MiFID no longer recognises Investment Exchanges. Under one of its key principles, competition, it is driving for a landscape made up of a multitude of venues with different regulatory headings but all authorised to facilitate the exchange of securities: Regulated Markets, Multilateral Trading Facilities (MTF) and Systematic Internalisers (SI). They are exchanges, but to survive in the new competitive global economy they have to be much more. The Exchange is dead; long live the exchange.

This may seem like semantics but there is a very important indicator to look for in the financial press. The new regulated markets positioning themselves for growth no longer simply offer an environment to facilitate the exchange of securities: they are becoming much more than that. They are commercial, driven marketing machines fighting for a foothold in a new and precipitous landscape. And so whilst some may be called SI, others MTFs and yet others RMs, their differentiator is not a regulatory label but actually the multi-faceted services they offer to their chosen demographic.

In less than a year we have seen the LSE go from being perceived as a cornered, weakened national exchange to a strengthening European, if not global, force. The organisation was staring first at the might of MiFID regulation that would seemingly weigh it down under bureaucracy and then at the talons of an ambitious American eagle. However, what we now see is an entity well aware of its importance in global trade and well aware of the threats that surround it. It has rapidly formed global relationships with the Tokyo Stock Exchange, with Borsa Italiana and with the Middle East. In addition, it commenced some time ago a review of services and is looking at technology that will give it an edge – both in terms of latency and Smart Order Routing – to potentially deliver Best Execution services. The LSE is transforming to become a more agile and competitive market.

Elsewhere we see other venues flexing their commercial muscle delivering new services either because MiFID has enabled them to do so or because they have had to as a direct response to competitors. Recently NYSE.Euronext announced its intention to provide a dark pool trading service, Equiduct, itself formed out of the enabling regulation, was recently bought by the Berlin Stock Exchange and finally OMX continue to develop their technology service offering.

In addition, of course there is the development of SIs and MTFs, although at this stage there is little information regarding the former – the CESR website currently states:

“Information concerning systematic internalisers will be added closer to November 2007”

And lists three very recent additions (added 30 October) – BNP Paribas, Nordea Bank and Danske Bank.

What is certain is that new MTFs are being considered to take advantage of MiFID and undoubtedly SIs are going to come to market shortly adding a further transformational dimension. As an aggressive response, there will be more consolidation and, as a defensive one, new initiatives such as market data services, trade reporting, Direct Market Access and Close Proximity Serving, to diversify the exchange product set. Added to these will be new tariff structures, not too dissimilar to those we are witnessing in the US where “Taker-Maker” models are used and in effect, venues such as BATS give rebates to those who give more liquidity than they take. As tariffs are reduced and algorithmic trading drives ever decreasing lot sizes, spreads are getting tighter. There is every reason for venues to deliver services based on Best Execution algorithms using Smart Order Routing software. New services are imperative to attract business but that is not something you would have levelled at an Exchange several years ago.

Soon it will be difficult to differentiate between those Tier 1 investment banks, who provide order routing services or trade off their own book for their institutional buy-side clients, and other venues’ trading services. The new Regulated Markets are shaping up to be something very different than they were 10, even 5 years ago to ensure they can compete against not only each other but also against as yet unknown competitors to their liquidity. They will have to offer a variety of services and maybe even go head-to-head with Tier 1s both commercially and logistically. If you don’t believe this article then read the MiFID text, the Exchange is dead.

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