

Mergers, Alliances, and ECN's.

How is technology facilitating the business drivers in the changing world of Exchanges?



The exchange traded market place has changed dramatically since 1997. The world economy and internal business drivers have caused new markets to be established, markets to merge and cross boarder alliances between exchanges. As this environment continues to change, it's clear new technology needs to be found, and existing technology needs to adapt. But what are the key changes in the business of the exchange that we have seen over the past decade?

By **Kathleen Grey**, Business Analyst, HSBC

■ 'Mergers' of Exchanges

During the past decade, cross border mergers, joint ventures and significant shareholdings has involved over 13 European cash equity exchanges. While these mergers have not resulted in the standardization of listing and transaction rules, or cross boarder regulation, there is an obvious movement towards standardization of technology being used by each exchange. Stockholm Stock Exchange, Helsinki Stock Exchange, and Copenhagen Stock Exchange all have a clearly defined individual index despite being under the OMX group's Nordic Market. The exchanges may have merged in terms of ownership across the region; however, this has not necessarily resulted in a merger of the physical market place. Each market remains subject to it's national regulator, participants and it's economy. Despite the ability for investors to trade across borders, listing rules, market

structure and transaction rules have not become generic. There have been changes made by exchanges to strengthen their competitiveness through diversification of products offered and attempts to gain international companies for listing. These are just two initiatives taken by many exchanges looking to increase profitability. While this may have expanded the base for some, as exchanges move to grow and stabilize their operations, the electronic trading platform used to manage and provide the market place appears to be the main operational factor becoming generic.

The past decade has also witnessed mergers between derivative and cash market exchanges. Led from Europe, and continuing in the US and now in Asia Pacific between the Australian Stock Exchange and the Sydney Futures Exchange. Mergers, 'friendly acquisitions' and joint

ventures have changed the way an exchange looks as a business – but not necessarily how the participants will interact with the physical market place when trading their particular instruments of choice. While there is the invention of new instruments, an equity is still an equity and a futures contract

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still a futures contract. They are still listed, bought and sold. So what does merge? The staff. The balance sheet. The Technology. The ability to provide access to market data and execution over the same platform for all products would reduce costs dramatically for an exchange.

When reviewing countries that have not yet entered into merging their major exchanges, there are some interesting relationships. In China the major exchanges include Shanghai Stock Exchange, Shenzhen Stock Exchange, Shanghai Futures Exchange, Dalian Commodity Exchange, and Zhenzhou Commodity Exchange. Although all separate exchanges, what we do see is an effort to provide standardized contracts, as highlighted by Dr. David Li at the 4th Asia Pacific Electronic Trading Summit May 2006 (refer to FIX Global Issue 10).

In Japan, a recent discussion at October's FPL Japan Electronic Trading Summit, revealed the opinion of the Osaka Stock Exchange that mergers of the markets would strengthen the international standing of the Japanese market. A school of thought not expected by the wider financial community to come out of Japan. While there does not appear to be any plans to merge the markets at this point in time, one could be led to believe we are likely to see mergers occurring or closer alliances set up between exchanges over the next 2 to 5 years.

With this view in sight, it's clear there will be some changes in technology used to access these markets.

■ International Alliances

A more recent phenomena has been the 'Alliance' between exchanges. During 2002 and 2003, the Shanghai Futures Exchange, Chicago Mercantile Exchange and Tokyo Stock Exchange formed an 'Alliance' for futures trading. This was followed by another 'Alliance' between the Chicago Board of Trade and the Taiwan Futures Exchange in late 2003. These Alliances are providing competition to the London International Financial Futures and Option Exchange and Eurex US, with markets offering 24 hour trading capability and bi-directional order flow between exchanges.

The business trends of exchanges are clear. It's technology that is making these trends work.

■ Electronic Communications Networks

A class-action lawsuit initiated in 1996, alleging collusion amongst Wall Street traders that NASDAQ market-makers set and maintained wide spreads pursuant to an industry-wide conspiracy. 3.5 years later, with a \$1 billion settlement from major Wall Street firms, a new regulation by the U.S Securities and Exchange Commission (SEC) gave birth to the "electronic communication networks," or ECNs.

The Limit Order Display Rule, implemented at the time the Nasdaq Market Makers Antitrust Litigation was settled in 1998, allowed for major ECNs to become active. Instinet and Island, (which were since merged into INET and acquired by NASDAQ), Brut (acquired by NASDAQ) and Archipelago

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Exchange (which was acquired by the NYSE) all commenced providing an alternative to the traditional Exchanges. Low transaction costs and matching orders outside of traditional exchange market hours have resulted in ECN's continuing to grow in number. Desire for anonymity has also been a driving factor in the growth in volumes traded over ECN's. The changes to the Regulation National Market System Legislation proposed by the SEC in 2004 for the US markets, combined with pressures from US institutional investors for faster execution and reporting of orders, lead to the acquisition and consolidation of ECN's. Fast execution, low cost, anonymous transactions is what ECN's provide to the market place. Their ability to do so has been facilitated by new technologies for electronic trading. One key technology being the FIX Protocol (of course!).

Some Exchanges have been dismissive of the threat of ECNs, given that they require a functioning primary market to provide price discovery and ultimate liquidity. While this may be the case, ECN's are continuing to emerge around the globe and provide an alternative trading place for participants.

The first half of 2007 will see the launch of a new Australian ECN "NewCo". The New Zealand Exchange Limited (NZX), Citigroup, CommSec, Goldman Sachs JBWere, Macquarie Bank and Merrill Lynch have signed a shareholders' agreement, incorporating a company to launch an ECN that will deliver market participants a choice in reporting services trading in this market place. The shareholders believe the time is right to introduce a degree of technological and price competition in a subset of exchange services currently controlled by the ASX.

The TrackECN platform used for this ECN will allow participants to connect and route messages using FIX 4.4. In the first half of 2007, the NZX is expected to move to a FIX only interface upgrading from FIX 4.2 to 4.4. By using the FIX protocol, the NZX is able to establish the leverage and scalability it needs as a business to stay competitive, in a region where a single economic market could emerge within the next 10 years.

The development of ECN's and Exchanges co-existing since 1998 has set a trend that is likely to continue in the foreseeable future. As the competition for order flow between Exchange and ECN grows, the electronic trading platform needs to adapt. The ease at which a market can be accessed electronically, the cost at which the connectivity can be maintained, the consistency of the technology used to access various markets and ultimately, the service provided by the platform to facilitate the complete lifecycle of a trade, are clearly recognizable as

trading platform leads to lower costs and greater speed of execution.

The past decade has seen constant change in the exchange traded market place. It would appear this trend will continue. What will the market place look like in 2017? No one can be certain. What is certain is that FIX will adapt, and play a major role in whatever changes take place.

For more information regarding the Exchange Working Group please email kathleengrey@hsbc.com.hk **FIX**

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business issues that need to be addressed by all market participants and market place providers. The FPL Exchanges and ECN's Working Group is attempting to promote standardization of FIX tag usage in the Exchanges and ECN community by working with exchanges and ECN's to produce a series of 'harmonization documents'. These documents do not propose new standards, but rather seek to provide a standardized approach for ECN's and Exchanges when using the existing protocol, therefore addressing the business issues associated with an electronic trading platform.

■ ECN and Exchanges Working Group

ECN and Exchanges Working Group commenced work in 2006. The aims of this working group are to make certain the FIX protocol is understood in the market place, and there is a common use of FIX tags. By working with Exchanges and ECNs, focusing on how best to achieve results where FIX is used, we are ensuring there is not only a common protocol available, but a standardized methodology is established, when using the protocol for exchange traded products. How best to support the trading of Equities, Exchange traded Futures, Exchange traded Options, Fixed Income, Foreign Exchange and Commodities, is currently being reviewed. The ultimate outcome of this effort? A more efficient trading environment. Less diversity in the case of the electronic



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