Connecting the dots

After the largest financial crisis in the history of the capital markets, what changes do we need to promote liquidity recovery? Investors and exchanges empowered with a choice of on- and off-orderbook mechanisms, dark and light, will innovate electronic trading to diversify by geography and asset class. We consider the bold ideas shaping the new landscape.

According to data from World Federation of Exchanges (WFE) members, global values traded on orderbook[1] in 2010 were still 30% lower than their peak in 2008. In the face of these constrained volumes, exchanges and alternative trading venues worldwide are looking for ways to increase on-orderbook activity. The two ways to do this are a) organic growth through innovation, or b) mergers and acquisitions. After three years of little to no activity in exchange M&A, the first half of 2011 has seen a spate of deals announced, including:

1. Australian Securities Exchange and Singapore Exchange (now blocked).
2. Tokyo IPO & the often-rumored potential combination with Osaka.
3. Russia's MICEX and RTS.
4. BATS and Chi-X Europe (referred to UK Competition Commission).
5. London Stock Exchange and TMX Group (subsequently withdrawn).
6. NYSE Euronext and Deutsche Börse (under review by The Directorate General for Competition of the European Commission).
7. NASDAQ OMX and ICE joint bid for NYSE Euronext (subsequently withdrawn).
8. Maple consortium counter-bid for TMX Group in Canada (asked for more information by Canada's Competition Bureau).

The proposed deals would combine some of the largest exchange operators in the world and some promise to be the subject of intense regulatory and potential anti-trust scrutiny.

New sources of revenue

As an alternative or complement to full M&A, exchanges are exploring new areas to generate revenues. Historically, the majority of exchange initiatives have failed. Those that do succeed, however, capture material new business. Many of these tend to be multi-market in nature. For example, Bursa Malaysia agreed to offer USD-denominated palm oil futures on the Chicago Mercantile Exchange. Eurex, the joint-venture exchange of Deutsche Börse and SIX Group, launched the EURO STOXX 50 Future with multi-market exposure, which surpassed each of the single-country index contracts to become the most liquid European index derivative. Similarly, Chi-X Europe, a multi-market, cash equities multilateral trading facility (MTF) started in 2007, became as of January 2010 the single largest orderbook by value traded in all of Europe – eclipsing the incumbent single country exchanges.

The Markets in Financial Instruments Directive (MiFID), enacted in November 2007, catalyzed the entry of new competitive cash equities trading platforms in Europe. Trading fragmentation, a consequence of competitive choice, was already a part of the United States landscape, which operates within a single country framework, with one currency, and one clearing and settlement destination. Europe is more complicated as a market place, characterized by different country rules, multiple post-trade providers and currencies. Europe, however, was able to solve the problem of trading in one market and settling in another via central counterparty (CCP) clearing models. This made it possible, for example, to trade Daimler on different platforms in Germany or the UK and settle all in Germany. Today, it is possible to trade European stocks on any exchange or venue and settle them in their home market.

Asia is the first region to duplicate this European solution. Chi East, the joint venture of Chi-X Global and the Singapore Exchange, allows investors to trade stocks listed in Australia, Japan and Hong Kong all in Singapore, yet settle respectively in their home central depositories. We understand that India also is exploring plans for interoperability between its two main exchanges, the National Stock Exchange and the Bombay Stock Exchange.

So we see that trading the same instrument on multiple platforms and settling in the home central securities depository works within the same region. The next evolutionary step for equities is to trade the same instrument in another region and settle it at the home market.

Changes to the securities trading environment mean more choice for investors.

[1] This includes on-orderbook cash equities trades executed on WFE member exchanges.

This would allow continuity of asset value calculation and trading even when the home market is "sleeping."

In this respect, non-equity markets show the way. Today foreign exchange (FX) instruments trade 24 hours a day and settle in one place, CLS Bank. Listed futures likewise trade around the clock and tend to congregate within the CCP that has the core open interest.

As we move towards an ever more global trading environment, the lessons of Europe as well as the experiences gleaned in FX and futures markets can be extended and expanded cross-border to include more global products on more exchanges for more choice and geographically diversified risk management. From an investor's perspective that means more potential to access available alpha around the world.

Regulators go global

To avoid "regulatory arbitrage" as products and trading expand, regulators must harmonize their initiatives. While there is no legal obligation for countries to do so, leaders are gathering at G-20 meetings to seed regulatory consensus.

As authorities craft new regulation, they are informed by their experience of equities, both client and proprietary trading, which performed well operationally during the 2008 crisis. In September 2009, G-20 leaders met in Pittsburgh and agreed that: "All standardized OTC

Come into the pool

Non-displayed orderbooks ("dark pools") and central counterparty clearing are two trading innovations which offer particular benefits to investors. UBS MTF, the first bulge-bracket broker multilateral trading facility with a central clearing model, offers its members the benefits of both.

Light and dark

Despite their ominous name, there is nothing nefarious about "dark" liquidity pools. In the most general sense, "dark pools" contain firm orders where the pre-trade price is not displayed. For particular trading situations, this can be a useful tool to help investors get the best results.

Executing trades by directly lifting offers and hitting bids on an exchange public limit orderbook are examples of "on-orderbook" trading. Because one can see the limit orders before a trade, these are called "lit" orderbooks.

Lit orderbooks offer the advantage of certainty, but suffer from market impact. Dark or non-display liquidity does not have certainty, but does generate high confidence in the confidentiality of the trade. The two modes of trading are a natural complement rather than a substitute for each other.

The benefits of choice

Central Counterparty Clearing (CCP) refers to the clearing and settlement of trades through a clearing house. By among other things reducing or even eliminating counterparty risk, CCP offers investors many benefits.

Europe introduced the concept of interoperability among clearing houses, meaning that clearing and settlement in multiple markets functionally can be consolidated into one counterparty.

This has seen the rise of the CCP "user choice" model, which allows international users to consolidate their clearing across markets in the CCP which has the best affinity with their commercial profile, without imposing switching costs on those domestic members that wish to remain with the incumbent.

In 2011, the user choice model enabled by CCP interoperability appears to becoming the rule rather than the exception. This emerging EU landscape, while appearing to fragment as more CCPs interoperate, in fact allows individual firms to consolidate their respective pan-European market flows to a single CCP of their choice to scale benefits.

UBS MTF

On 9 November 2010, UBS announced the launch of UBS MTF, the first broker operated multilateral trading facility (MTF) to feature a central clearing model.

UBS MTF is a non-displayed order book. As a 100 percent non-displayed liquidity pool, there is no pre-trade signaling risk or display of any kind. Executions completed in UBS MTF are reported post-trade in real time to the Markit BOAT trade reporting facility.

UBS MTF offers mid-point matching based on the price of the primary market. In response to its participants and with approval of its regulators, UBS MTF will offer the ability to peg orders also at the bid and offer.

Its CCP model benefits members by assisting them in mitigating counterparty risk and contributing to reduced settlement costs. In July 2011, UBS MTF announced that, along with SIX x-clear, it had activated EuroCCP as a clearing counterparty, becoming the first MTF in the world to offer full clearing interoperability with cash equities. In August it said it planned, pending regulatory approval, to add EMCF and LCH. Clearnet as well, thus offering four-way interoperability.

ubs.com/mtf

derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.[2]"

The shift from over-the-counter (OTC) to CCP for derivatives may confer scalability on segments of that market. Some risk exposures currently transferred more easily via the OTC trade lifecycle process may trade seamlessly as products on-exchange, where it will be possible to enter and exit these positions more fungibly, more frequently and with greater simplicity than before. As a result, one expects trading of these products, if implemented well, dramatically to increase.

The global approach to regulation will also continue. In November 2010, the G-20 met in Seoul and endorsed a number of global regulatory initiatives, including Basel III, the Financial Stability Board's Systemically Important Financial Institutions (SIFI) framework and the rebalance of IMF ownership to include more emerging market countries. The meeting marked the first time a non-G8 country hosted a G-20 meeting, and it is noteworthy that Singapore, currently not a member of the G-20, was invited to participate. The location, participants and subjects in Seoul demonstrate a commitment from global leaders to establish an inclusive style of governance, one which will be carried on at meetings in France in 2011 and Mexico in 2012.

Conclusion

The impending changes impacting global trading, clearing and settlement of cash and derivative instruments challenge the status quo for all market participants. New and revised regulations may add operational cost, but also opportunities for innovation, new clients, new products, new competition, new behavior and new trading strategies. The insight is that exchanges wishing to promote liquidity recovery and remain relevant in an increasingly competitive environment will need to diversify offerings by geography and asset class whether by acquisition or innovation.

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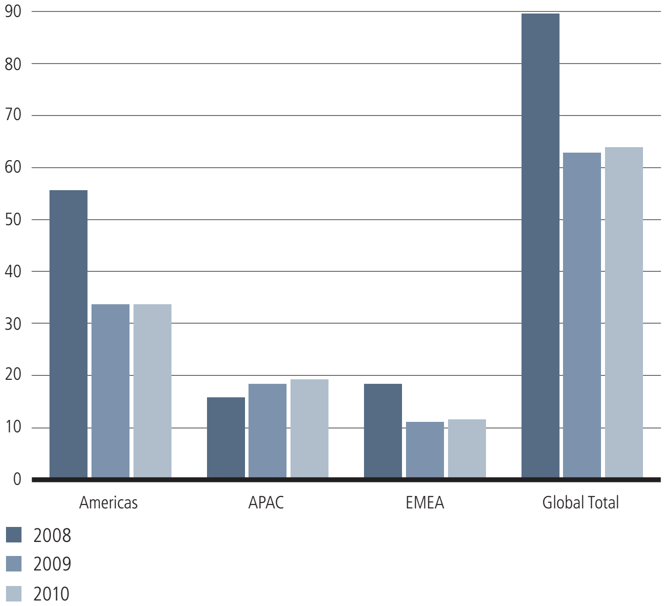
Figure 1

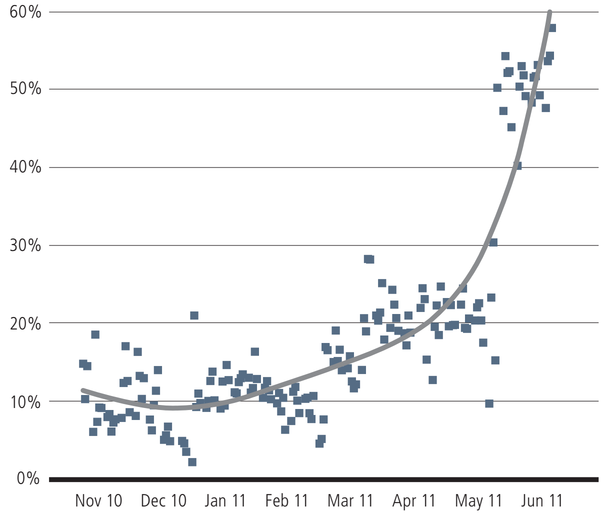
Equity orderbook values traded
In USD trillions



Source: World Federation of Exchanges

Figure 2

UBS MTF – an expanding stock universe
Stocks matched on UBS MTF as a % of orders received



- UBS MTF stock universe includes more than 2,600 large, mid and small caps.
- A number of these instruments are not available on other recognized MTFs.
- Participants are increasing numbers of stock names in which they send orders, and the ratio of names matching relative to orders available is accelerating.

Source: UBS data

[2] Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, 15 September 2010, page 2.