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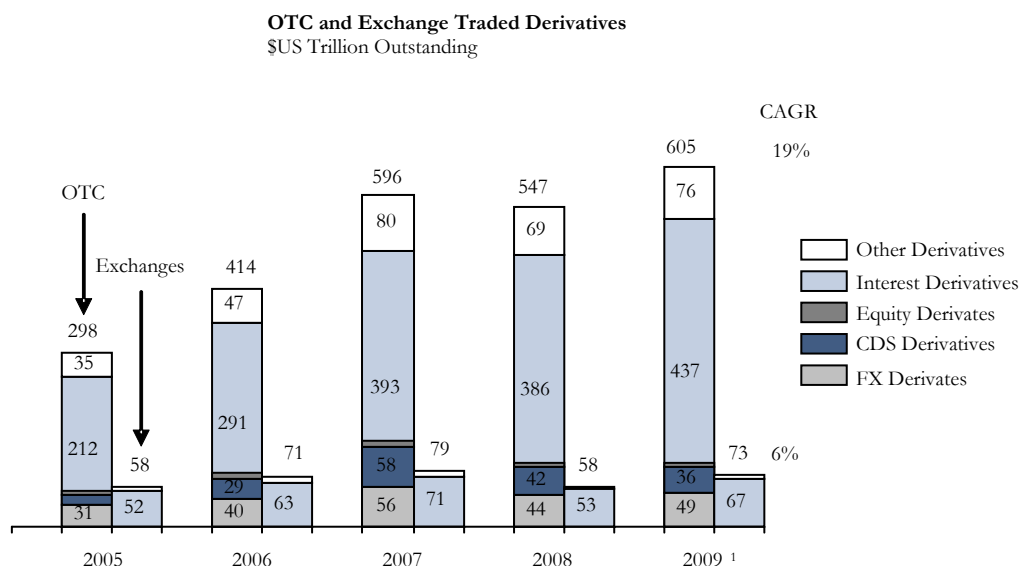
The Evolving Roles of Exchanges and Inter-Dealer Brokers

This is the first in a series of Cairneagle white papers on the evolving roles of Exchanges and Inter-Dealer Brokers (IDBs) in the Financial Services industry. In this paper we discuss the growing presence of the OTC market and IDBs, and the impact of this on Exchanges.

When City of London greybeards gather, the tale is still told of the London Stock Exchange official who had grown a little too big for his boots; he had developed the habit of referring to stock brokers as ‘My members’. Retribution was swift; one of ‘His members’ turned up at his office one day, and while pleasantly engaging him in conversation, proceeded to eat fish and chips from its paper wrapper spread all over the offender’s desk, leaving him in no doubt about who the master and the servant were in that particular relationship!

And so it has continued over the years, the Exchanges being the servants, the bureaucracy, the second rate. Exchange staff were seen (often rightly) as dull civil servant types while Exchange heads were the second division senior managers of investment banks who were never going to make it to the top and placed in the Exchanges to ensure the interests of their erstwhile masters were protected.

Exchanges were, by and large, ‘not for profit’ organisations – the commonly held utilities to better facilitate the business of the investment community – or more properly the sell side of the investment community; for buy side influence over Exchanges has been very slow in coming. In the light of this role, it is surprising the amount of attention paid to the Exchanges by the public and the media. Anyone who did not know the industry could be forgiven for thinking that Exchanges were at the centre of the securities industry whereas most industry insiders understand that they are, at best, bit players. The majority of securities industry transactions go around Exchanges rather than through them. Government bonds, commercial credit, swaps, credit derivatives, CFDs, CDOs, stock borrowing, the list is long of those instruments which trade largely or wholly over the counter. By contrast the number of instruments traded on-Exchange: equities, options, index futures, etc is relatively small, both in number and value, as the chart below shows.



The dominance of OTC markets has increased over the last 20 years as most new products created by investment banks have been deliberately placed outside the reach of Exchanges. The standard life cycle of new financial products begins with the newly invented product being offered bi-laterally from the investment bank to a chosen group of its clients. As the product develops, the investor group expands and other investment banks offer similar

products. The industry then moves to standardise the terms of the products to allow fungibility and secondary market activity. Finally, when the marginal profitability of a product is reduced below the attention threshold of the average investment banker, the products may be commoditised and moved into an Exchange trading environment where lower costs and risks means that the reduced marginal revenue still represents a profit for the sell side firms, whose focus has meanwhile moved elsewhere – to the next big idea.

The function of Exchanges has therefore been as much to draw attention away from the real markets as it is to provide markets. They have provided a convenient focus for the layman, the politician and even the regulators, who have found it easier to intervene in the world of Exchange traded equities than in the murky world of off-balance sheet derivatives. When they have attempted to extend the reach of their regulations to largely OTC markets like bonds and swaps, the regulators have faced an avalanche of criticism and have often been forced to beat a hasty and undignified retreat, as was demonstrated when the idea of forcing pre-trade price disclosure in bonds was floated.

There have been some changes in this situation over the last ten years, the biggest of which has been the demutualisation of many Exchanges and their transformation into commercial as opposed to ‘not for profit’ organisations. This move was resisted for many years by the Exchange members, who preferred to keep that particular genie safely in the bottle. But in a world where Exchanges were merely bit players, such concerns became rather outdated; additionally, as owners, the sell side firms started to see the idea of selling off Exchanges less as a strategic error and more as a profit opportunity.

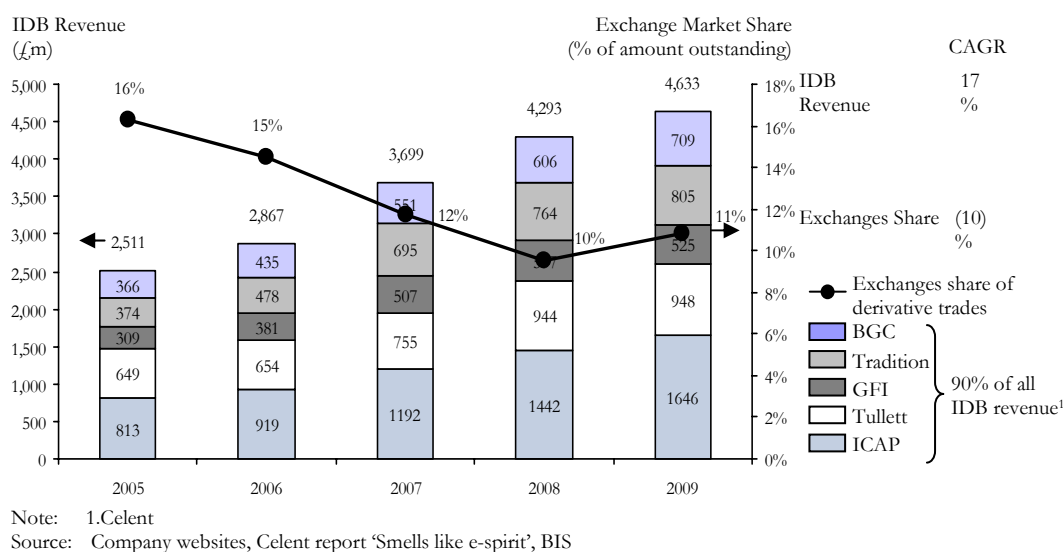
The changed status initially proved little more than window dressing for many Exchanges. The personnel, ambition and strategy of the Exchanges remained stuck in a ‘servant’ culture; they may have been all dressed up but they had little idea of where to go. There was, of course the inevitable flurry of take-overs; like teenagers with their first credit cards, the Exchanges tried out their new found freedom in a round of acquisitions and mergers; but despite the generalisations about ‘strategic opportunities’ these mergers have actually yielded little except fees for investment bankers and a speculative bubble in Exchange valuations. Recently however things have begun to change and while most Exchanges remain weak and reactive in their policies, for one or two the glimmer of a more strategic, pro-active future has emerged. New CEOs with serious track records in investment banking have been drafted into Exchanges and have brought with them some highly skilled and motivated people. What they are looking for now is the model for future growth.

The IDB example

A major inspiration for the ‘new Exchange’ has come from a type of firm which has seen extraordinarily growth over the last decade – the Inter-Dealer Broker. Firms like ICAP, Tullett Prebon and Tradition have long since outgrown their own ‘utility’ roots, as money brokers, oiling the wheels of the market, and have become one of the success stories of the securities industry. While both sides might be loath to admit it, there are many similarities between the IDBs and the Exchanges: both provide a mechanism for broker dealers to trade with each other, both provide an anonymous execution facility and both do this without the use of a bank-sized balance sheet. However there are also key differences, which explain performance disparities between the two groups.

The first of these differences is business flexibility. Unlike the Exchanges who obsess about their role in the markets, IDBs worship no god but Mammon. Whatever it takes to make inroads into a new business area is all right with them. If a market works efficiently with voice broking, they will use just that; if it needs high volume, low value trading, they will offer electronic routing; if price discovery is needed they can provide that also, and if it is price obscurity you want, then no one hides a price like an IDB! By contrast the Exchanges have appeared to be stuck in one operating mode; they have been obsessed with bringing new markets onto their existing platforms; ‘leveraging technology’ has been their mantra. This has provided a cost-side justification for their shopping sprees but has proved a dead-end from a revenue point of view. By focussing on adding new businesses to their existing technology platforms the Exchanges are simply behaving in the way we would expect utility operators to act: looking only for businesses that fit their ‘really useful engine’ rather than seeking out and responding appropriately to a wide variety of potential major revenue earners.

IDB Revenue and Exchanges Share of Derivative Trades



The second difference between the IDBs and the Exchanges is in their personnel. IDBs have been prepared to compete with the investment banks for staff. This is not merely a salary issue; indeed many Exchanges now pay significant amounts of money for their staff; it is a bundle of issues including conditions, bonuses and above all culture. IDBs are often criticised for their 'robust' approach to staff culture, and while no one could condone the excesses in certain firms, there is no doubt that staff in IDBs have a status in the securities industry which Exchange staff do not. The identification, promotion and reward of talent has been central to the success of IDBs, and the corollary has been the curse of Exchanges.

Thirdly, and perhaps most importantly, the IDBs tend to be 'product led'. Where the Exchanges have responded to market requirements (management speak for being re-active rather than creative) the IDBs have sought out money-making opportunities. When a business opportunity is discovered (note they have to be discovered – they rarely present themselves), the IDBs have created a product solution – sometimes a body on a desk with a phone, sometimes a fully fledged electronic trading system. Concerns about 'waiting for customer requests' or 'fitting into the existing platform' come very low down the list of IDB concerns when money is on the table. By contrast the Exchanges have been obsessed with gathering assets onto their existing platforms rather than exploring the new. Much of this problem is down to the acceptance by Exchanges that their products are inevitably low value, high volume. The IDBs, by adopting a matched principle approach to much (though not all) of the business they support, can take a significant proportion of trade value, whereas the Exchanges have been caught in a 'fixed fee' trap – a legacy of their utility roots.

The similarities between IDBs and Exchanges have not been lost on the CEOs in both camps and the (not very) secret merger negotiations between the London Stock Exchange and ICAP in 2006/7 showed that both sides see possibilities in a tie up. Sadly the failure of these negotiations also demonstrates the difficulties involved. The mismatch of cultures is palpable and while those at the top may share a vision, many IDB staff could well vote with their feet if faced with a future as Exchange employees.

Whether or not the Exchanges eventually merge with IDBs they can certainly benefit from studying them, and particularly one feature of the IDB business model: the ability to make high levels of return with relatively small balance sheets.

Our next article explores how Exchanges (and IDBs) can develop their businesses in the future, and avoid the current trend of declining profitability in their traditional activities.