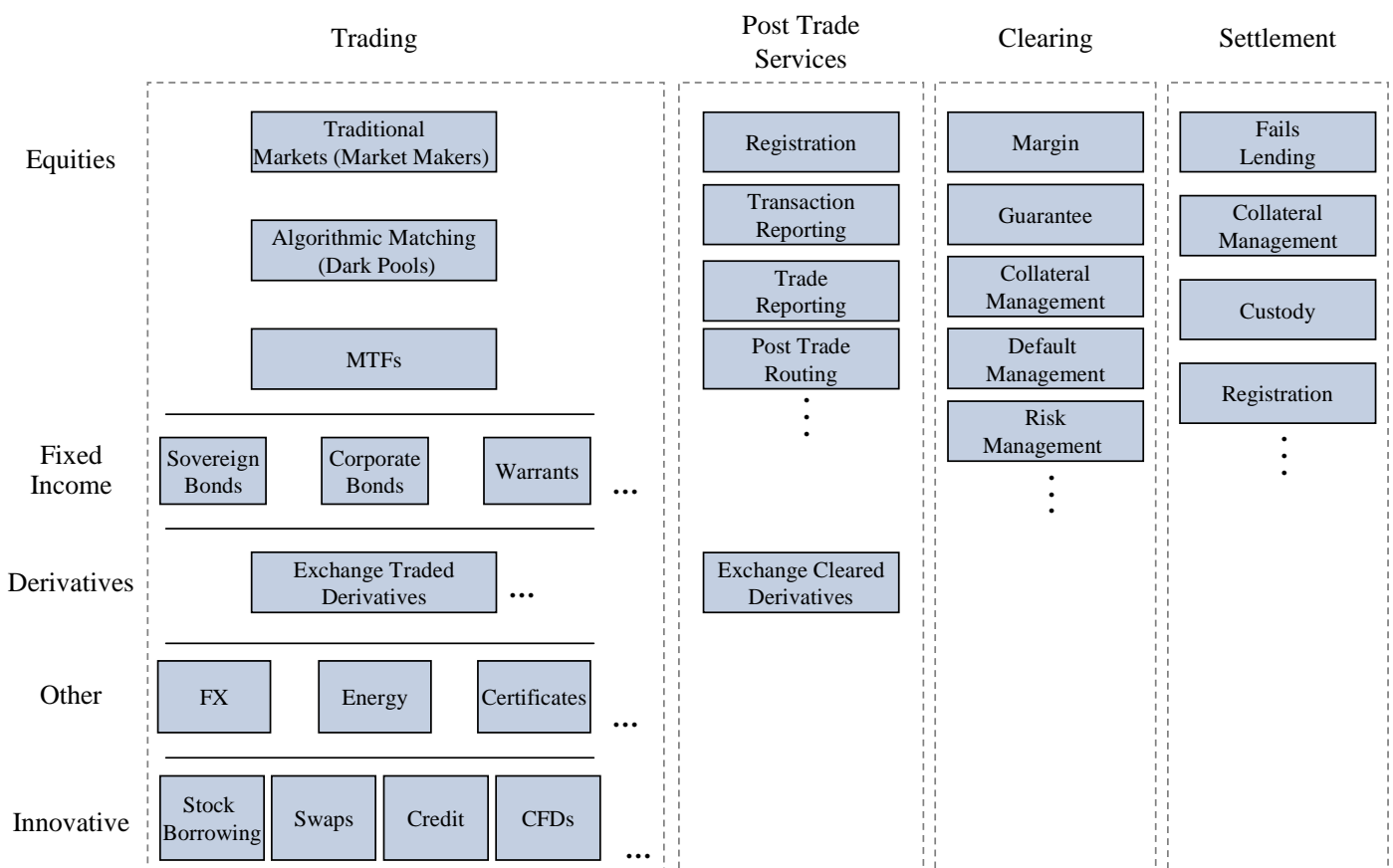


The Full Service Exchange – Within our grasp but is it desirable?

Over the last five years there has been a radical overhaul of the Securities Exchange business. Many Exchanges have changed their corporate structure from ‘not for profit’ member owned entities to listed companies which are very much for profit. At the same time they have been engaged in a flurry of consolidation with a number of significant acquisitions and mergers. Up until recently no standard universal model of the exchange has emerged. Many exchanges have continued to focus on one or two core products while others have expanded into derivatives, bonds, swaps, etc. Some exchanges have stuck to one tried and tested trading model while others have grasped the opportunity to develop multiple trading approaches. Some exchanges have defined their future as trading facilitators while others have created silos which provide a full service from pre-trade price discovery through trading, clearing and settlement. It is no wonder that the question “What is a Stock Exchange?” is rarely asked these days and even more rarely answered.

However in the last year or so the mists have started to clear and it has become possible to draw up a meta-model of the full service exchange which some operators seem intent on creating (though none are there yet). The model in figure A is an overview of what such an exchange might look like.

Figure A: Exchange model



A full service exchange as described by such a model does not merely trade multiple instrument types, but offers multiple mechanisms for trading the same instrument type: e.g. Market Maker systems, dark pools and 'open/flat' MTFs to trade the same equities. The full service exchange does not stop there, it provides the full range of post trade services and increasingly exchanges are realising that clearing, if not settlement is a crucial element of exchange functionality as without an 'in house' clearer (or at least a friendly CCP) the successful introduction of innovative products trading in areas like OTC derivatives, is virtually impossible.

The question must be posed however, whether the full service model is best for most, or indeed any, stock exchange. The gathering of assets into the new, 'for profit' exchanges, seems logical at first but where does it end? The idea that we will end up with one or two global exchanges dominating all trading may be attractive to some but to others it is a very dubious value proposition. And what does all this get the shareholders of these publically owned entities? Yes they can become big, but can that size be translated into profit? Most importantly we would note that most large commercial conglomerates (and the 'full service' exchange is indeed a financial services conglomerate) do not merely acquire assets, they nurture them, make them independent and take their profits through sales, IPOs etc. Few exchanges have yet crossed that particular bridge but it is logical that such a strategy must be included in the options of a commercially driven exchange.

There are multiple development paths for exchanges and the question many exchange operators must ask themselves is where they stand on their particular development path? Which assets can be effectively added, which are necessary and which are simply 'nice to have'. There are a multitude of possible postures but here are some that we at Cairneagle have already identified:

- **The Trading Niche Player** – Exchanges which concentrate on trading services for a particular market segment (e.g. derivatives or commodities). Often tied to a single Clearer they lie open to the predatory advances of the full service players and yet may survive and prosper because they are specialists in an area which has a specialist user base.
- **The Full Service Niche Player** – Concentrates on a particular part of the business (e.g. Equities), but for that segment provides a full service with pre-trade, trading, post trade and clearing solution in-house. Provides an efficient service to users but is increasingly squeezed for price by larger competitors and has limited profit making opportunities.
- **The Trading Solutions Exchange** – Such exchanges offer a wide variety of trading mechanisms tailored to suit different users: Dark pools, light pools, block trading, small trades, retail, etc. Such entities can be innovative with markets and may be prepared to joint venture with other market participants to get a new market off the ground. However their lack of post trade and clearing capabilities means that they are always subject to the commercial whims of the providers of such services.
- **The Behemoths** – Exchanges dedicated to being all things to all players. These exchanges have embraced the idea that they must offer all trading and post trade facilities for everything their customers trade, or might wish to trade. Their expansion plans are to acquire assets and extend their global reach by partnerships or acquisition. The challenge they face is establishing the real value of the synergies upon which their business model is based. These exchanges may be the first to see that certain assets are surplus to requirements and can be profitably spun off from the operator.

All of these are legitimate and potentially profitable commercial postures for exchanges, but each of them brings about a different set of challenges. As we move from the hectic phase of acquisition and growth to a period where hard commercial question will be asked of exchanges it will be necessary for operators to articulate what their proposed posture is and what end position it will deliver.

Cairneagle Associates, with its unique mix of business strategy skills and financial markets experience is well placed to explore the strategic options for exchanges as they move into this uncertain future.