Consolidation of global financial exchanges

Economics, Financial Markets

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1. 0 Introduction:

Exchanges in various geographical locations have been established to provide a physical marketing place where the buyers and sellers of shares and other securities could meet to finalize the transactions mutually (Tabb L 2006) In the last two decades of the 20th century the stock market operations had undergone a number of changes. Especially the advancement in the information andcommunicationtechnologyhad a significant effect on the changes in the equity market operations. Until the period of 1990s the exchanges in various parts of the world were functioning with the primary objective of serving only their members. The structure of the exchanges and the systems of trading established traditionally was considered adequate till that point of time. However, there were certain other factors influenced the structure of the exchanges and compelled them to move towards a consolidated global exchangeenvironment. These factors can generally be grouped under three heads – technological factors, competitive factors and regulatory measures. These factors were influencing the exchanges individually as well as with a combined force. During the period of late 1990s and early 2000s there had been considerable technological improvements that pushed the consolidation of exchanges forward. With this background this paper brings out a clear and concise description of what is meant by consolidation of global exchanges and what are the impacts of such a phenomenon on the various capital markets. The paper also details the magnitude of the change in the exchanges in this direction.

2. 0 A Brief History of the Exchanges:

The stock exchanges have a long history in which a sea of changes had taken place over the period of time. The stock exchanges witnessed major changes like the change in the commission system from a fixed service charge to per transaction basis and also development of ‘ Electronic Communication Networks’ (ECN). These changes had substantial impact on the ways in which the world now makes various deals in the exchanges and also on the various players in those exchanges (Grossman, 2006)

Another major change that has occurred along with the formation of the European Union and various other deregulatory measures is the formation of an ‘ equityculture’. Before the period of 1980s the business houses in Europe had depended mostly on the debt capital for running there businesses and the equity form offinancefound very little exposure among them. This is in stark contrast to the situation prevailed in the United States where the equity form of financing was popular since a long time and this had given rise to an active secondary market for dealing in the equities. However towards the end of the 20th century the performance of the European equity markets surpassed that of the US markets thanks to the introduction of technological advancement in the stock exchange operations. As at the year 1998 almost every stock exchange in Europe had introduced electronic operations and in that way pushed back the exchanges in the United States by almost a decade. (Grossman, 2006)

3. 0 Consolidation of Global Exchanges – An Overview:

According to David Ellis (200&) there are primarily two sources for generating revenue for the exchanges. They are; providing market data on the securities of the listed pubic companies and the fees they charge for the listing shares of a publicly traded company. The income will grow only when there is an increase in the volume of trading done by these exchanges. Since the amount of fee being collected by the exchanges on each trade the investors are entering in to, is very less the exchanges are always on the look out for enhancing the volume of their trading transactions. This the exchanges can achieve by merging or consolidating their operation with the other firms. The exchanges adopt two methods for consolidating the operations. The exchanges accomplish the consolidation either by merging or partnering with each other or by maintaining the linkages through advanced technological means. Thus consolidation means an increase in the revenue of the exchanges. Consolidations also result in lower additional costs.

Consolidation of exchanges implies the merger or other form of cooperation between the exchanges located geographically apart to take advantage of the increased trading activities.

The other major advantage of consolidation is that the customers are able to get better investment tools. For example exchanges like NASDAQ or NYSE Euronext are in a position to offer broader investment tools to its existing customers because of their global positioning. Andre Cappon, the President of CBM Group (one of the capital market consulting firms in the US) says " The real game is about being able to offer multiple asset classes - equities, derivatives and options - all in the same place." Thus the distinct advantage of global consolidation is increased investment opportunities for the investors without geographical barriers. (Ellis, D)

4. 0 Current Trends in the Global Consolidation of Exchanges:

The formal acquisition of Euronext by NYSE happened in April 2007 and the agreement between NASDAQ and OMX Nordic Exchange happened in May 2007 and these two cross border consolidations marked the first step towards the global consolidation. (Clary, 2007)

The Economic Times reports that the acquisition of the third oldest exchange in the United States the Boston Exchange marks the active wave of global consolidation of exchanges. (ET 03/10/2007) Presently the consolidation activities are very brisk in both Europe and the United States. One of the potential candidates for takeover by another exchange is Philadelphia Stock Exchange which controls on an approximate estimate about 15 percent of the US options market. Talks are on the way for a possible takeover by NASDAQ. There are speculations about the possibility of a takeover of the New York Mercantile Exchange, which deals in commodities including gold and oil. Chicago Board Options Exchange is another likely candidate for merger. With the number of exchanges in the US available for merger getting decreased, the larger exchanges are looking for intercontinental financial market merger deals. While the markets in India and China are still in the developing stage, the next target is on the exchanges in Latin American countries like Brazil. Brazilian Mercantile and Futures Exchange and Sao Paolo Stock Exchange are some of the major exchanges in the Latin American region fit for a possible merger with other major European or American Exchanges.

There are indications that theMexicanequity exchange Bolsa Mexicana de Valores may be considered for a possible takeover by the Spain counterpart Bolsas y Mercados Eploes. Even the exchanges in the Middle East region have become the potential target for possible mergers. Borse Dubai and Qatar Investments Authority are trying to establish ties with NASDAQ or other major exchanges to present themselves as the financial hub of the Middle Eastern Region.

According to Andre Cappon it is highly likely that in a few years hence from now there may emerge an environment where a majority of the stock exchange activities will be centered on three major actors such as NYSEEuronext, NASDAQ and Deutsch Boerse – the German Stock Exchange. This will result in three or four major global exchanges that will control the entire stock market activities of the world across different time zones. The following figure represents the current trend of the consolidation activities in the exchanges across the world.

5. 0 Factors contributing to the Consolidation of Exchanges:

Mutual ownership was predominantly the structure adopted by the exchanges from the inception until the period beginning 1990. In other words the exchanges were existing as an entity primarily to serve their own members. In fact the exchanges were owned by these members themselves. The trading was being done in the traditional ways by open outcry or similar other methods depending on the custom followed by the respective exchanges on the exchange floors. This structure of the functioning of the exchange was adequate and found to be fitting the expectations of the members during the fist couple of hundred years of existence of the exchanges. After the period of 1990 there has been a considerable change in the structure and functioning of the exchange which was necessitated by a combination of the effect of various external forces acting on the exchanges. These forces can broadly be discussed under three distinct headings as below:

5. 1 Technical Factors:

In the period between late 1990 and the beginning of the 2000s marking the start of the 21st century the world witnessed unprecedented advancements in the information and communication technology area. These advancements have mostly forced for the consolidation of the exchanges.

According to (Randy Grossman, 2006) " Tighter market linkages, the advent of smart order routing and subsequent development of algorithmic trading and direct market access all have had major effects." As a result of the technological advancement, the exchanges were under tremendous pressure to handle more number of transactions with a greater speed. Those exchanges that did not have the resources internally to meet this challenge had the options of either buying the technology and the expertise or merging with capable partners.

5. 2 Competitive Environmental Factors:

The consolidation of exchanges was also promoted by the competitive environment prevailed in the stock market generally. On one side due to the technological advancement the exchanges were under pressure to maintain their market share. On the other side the shareholders of the listed companies wanted to ensure that their share value grows. This had put additional pressure on the exchanges to transact more business and when needed they resorted to other exchanges to meet the competitive needs. The following table indicates the effect of various competitive drivers on the exchange consolidation.

5. 3 Regulatory Factors:

According to James Angel the two factors that drive the evolution of the stock markets are technology and the regulation (Martin M, 1999) The Markets in Financial Instruments Directive (MiFID) and Reg NMS are the important regulations that have a profound effect on the stock exchanges in the Europe and the United States respectively. The objective of these regulations is to ensure that the dealings in the exchanges are made the best executed ones with orders sent to the exchanges with their best prices displayed. The market linkage developments to ensure this were left mostly to the market participants and the exchanges themselves by the authorities in both Europe and the United States. This had a very positive impact on the capital markets which further necessitated the changes in the structure and operating systems of the exchange towards the direction of consolidation.

6. 0 Consequences of Global Consolidation of Exchange:

The option to consolidate with other exchanges brings lot of strategic consequences to the merged entities. The following consequences are most likely to take place with the global consolidation of exchanges.

The opportunities for entering into new market activities like derivatives and commodities will increase for the exchanges desirous of merging if one of the partners caries on trading in any of these activities.

There are increased chances for an exchange to attract global listing of the securities which provides added advantage to the exchanges. This is true particularly in markets where the opportunities for equity financing by corporate entities in the form of Initial Public Offerings (IPOs) or other form of financing is ripe and active. Examples are the markets in the emerging economies like China, India and the Middle East as well as in the industrially advanced economies like US and Australia.

While the exchanges engaged in consolidation can keep their sources of revenues like cash listing, cash trading and provision of market data the additional sources of revenues could be assessed and added to be shared on a mutually agreed basis. This provides the exchanges to maintain their autonomy and at the same time accelerate the momentum required for growth which is a distinct possibility in the consolidation of the exchanges.

The consolidation of exchange will increase the chances of the exchanges to capitalize on the latest trends in securities trading. With the continued growth in these two areas, this includes building know-how on how to capture, process, package, and resell data for algorithmic trading; broadening end-to-end product to include cross-asset class trading, driven by hedge funds, proprietary trading desks; and trends towards active risk management practices using risk transfer mechanisms (e. g. derivatives trading).(Ding 2006)

By a process of consolidation the exchanges are in a position to assimilate the required knowledge and expertise in managing the opportunities and threats associated with the regulatory forces. For example in the European context by following the guidelines and requirements of MiFIID the exchanges could derive maximum knowledge in the ‘ best execution of transactions, internalization practices, pre-trade quotation procedures and post-trade reporting’.

7. 0 Effects of the Global Exchange Consolidation:

Bennett (2007) identifies the following economies arising out of global consolidation of exchange s:

Increase in the skills relating to data processing and communications

There can be sharing of technologies

Post-trading data saving and retrieving process knowledge can be acquired and

There will potential customer savings.

Global consolidation of exchanges results in distinct advantages to the following constituents of the stock market. The advantages result both directly and indirectly to these constituents

Exchanges involved in the merger

Investors in general

Stock brokers and other intermediary agencies

Business corporations

Economies of the nations involved

7. 1 On Exchanges:

For the exchanges involved in the consolidation it is global trading and enhancement in revenues through increased activities. The global consolidation slowly will lead to standardization of the markets world over and this drives ahealthcompetition among the various exchanges. In the case of regional exchanges the consolidation increases the opportunities of the exchanges becoming allies in the light of competition from larger global players. Similarly partnering with other exchanges enable the smaller exchanges an increased presence in the other geographical regions and hence they will be able to acquire and sustain a market position in the other geographical regions of the world. The consolidation also reduces the development and operational cost of information and communication technology measures the exchanges have to take to keep them up to date. This may be possible by sharing of the total costs by the participating exchanges. The measure of the consolidation is a cleat way of creating a critical mass of liquidity with a view to attract the investors and intermediaries from various international locations. (Thedeen E, 2007) In addition the exchanges also enjoy considerable saving in the information and technology cost. (Mandate)

7. 2 On Investors:

With the potential for good savings and investments the investors are seriously looking for new avenues of investing their resources to earn maximum returns with minimum risks. The idea of consolidation of exchange provides an opportunity for the investors to deploy their resources in the best available stocks irrespective of the geographical location where the investor domiciles. This gives the investor a wider choice of securities with a possibility of greater returns. The investor may find the stocks of some companies with global presence are really attractive to invest. Previously unless he resides in the region where the shares are listed he would not be able to make the investments in the shares of those companies. The investors can also enhance the medium of their investments by investing in derivatives, options, bonds and commodities in addition to the equities. This way the investors are able to increase the value of their investments. With the global consolidation of the exchanges now the investors are placed in a comfortable position to invest globally. Moreover the market knowledge of the investors is bound to encompass the movements of stocks being traded in different exchanges.

7. 3 On Stock Brokers and Other Intermediary Agencies:

Perhaps this constituent of the stock exchange Industry may derive the most advantages out of the consolidation of exchanges. With increased presence in the global locations the stock brokers and other intermediaries would be able to enhance the number of customers they serve and in turn there will be considerable increase in their revenues due to the increased volume of trading. There is also bound to be a tremendous improvement in the knowledge base of these intermediaries as they may have to keep abreast of all latest procedures and systems of different exchanges all over the world as the consolidation unites the exchanges subjected to different regulatory measures of different countries. With the increased market knowledge of different exchanges the stock brokers are better placed to give quality and reliable advise to the investors and clients to plan their investments properly and profitably.

7. 4 On Business Corporations:

The business houses, especially those looking for additional capital for profitable project proposals are placed in a better position with the emergence of the trend for consolidation of the exchanges. The companies will be able to bring out IPOs in any exchange where there is a favorable climate exists for new equity investments. By the use of ADRs in the American bourses the companies will be able to mobilize the capital required by them. The consolidations of exchange may also facilitate cross border mergers and acquisitions among business corporations due to the ready availability of the market information of the corporate entities involved in the proposals for mergers. Similarly the quoted prices of the shares of the companies may also be easily ascertained. The companies may take the advantage of listing in the exchange in a country where the regulatory measures are favorable. It is also quite possible for the companies to use different forms of instruments or ways for sourcing their capital requirements.

7. 5 On Economies of the Nations Involved:

By promoting cross border investments the connection of exchanges promote the flow of capital in between countries which may turn out to be advantageous to the economies of the countries concerned. Because of easy availability of additional capital the competitive strength of the companies increase and this in turn makes the economies stronger. The inflow of foreign direct investments and foreign institutional investments in the securities of companies who has a strong international presence is a great advantage for the economy of a country.

8. 0 Obstacles for Global Consolidation of Exchanges:

Ellis (2007) opines the biggest roadblock currently obstructing the further growth of global consolidation of exchanges is the bleak credit market conditions as they exist presently. As it appears it may take some more time for the global economy to revive till such time there may be sluggishness in the activities relating to the consolidation of exchanges. However the smaller deals like Nasdaq' s proposed deal to take over Boston Stock Exchange may go through the chances for larger merger appear to be less and they may be delayed. But according to experts in the field, the major hurdle for global consolidation is the regulatory frameworks in the respective countries. This is particularly critical in the case of exchanges looking for cross border mergers. Those exchanges have to obtain the approvals from two countries which necessitate the proposal to pass through two regulatory bodies having different regulatory standards. With the political considerations added to the passing of the proposals for cross border merger of exchange is really a daunting task. However experts of the opinion that the regulators may not be able to permanently contain the proposed activities of consolidation and they are bound to take a major leap in the near future.

9. 0 Analysis of the Concept of Global Consolidation of Exchanges:

The important aspect in the context of global consolidation of exchanges to be considered is the advantages the concept brings home for the various constituents and agents involved in the chain. From the discussions on the effect the global consolidation has on the various strata of people affected by it is observed that the consolidation of exchanges is resulting in a number of advantages to all the constituents. In thisrespectthe consolidation of exchanges could be considered as a welcome change in the sphere of stock exchange operations.

Considering the effect on the economies of the nations involves it may so happen that there is a drain on the capital from an economy which is already lacking in investments. It may be the case that the investors in their desire to earn a higher return invest the available savings in the securities of the companies belonging to stronger economies and this may be detrimental to the weaker economy.

However with proper regulatory measures such fight of capital out of a country may be regulated. But in that case the global consolidation may not produce the desired effect;

There is another potential danger to the economies in that even for slight changes in the political conditions or other changes in the economic policies the volatility in the exchanges will be too pronounced as there will be rapid movement of stock prices and the number of transactions taking place in the consolidated exchanges. The foreign institutions may suddenly decide to withdraw their investments depending on the events and such decisions can be given effect to instantly which will seriously hinder the economic growth of any country.

The investors would be carrying a greater risk in respect of their investments as the share prices in the global markets may move erratically depending on any economic events happening in various regions of the world. This scenario is being presently witnessed in the major stock markets even when they are not consolidated. With the global consolidation of exchanges the effect of such economic shocks may be tremendous for the investors as well as for the economies involved.

As Tabb (2006) observes irrespective of the competency levels of the regulatory authorities the future and success of the global consolidation is in the hands of such regulators as in any country. Hence it appears that even though there is a good response for the global consolidation still the local competitive would be in full swing thanks to the control mechanism being operated by the regulators.

10. 0 Future Outlook for Global Consolidation of Exchanges:

The efforts on the consolidation of the exchanges will continue vigorously through the next decade or so with larger exchanges becoming even larger by merging with other exchanges or looks for smaller exchanges that exist at the national or regional level so that the larger exchanges can sustain their growth. There are two possibilities for this to happen. The exchanges will merge with other larger exchanges or become partners or alternatively they can use the technological developments to maintain the links with other smaller exchanges. An example in this direction may be found in the creation of the new trading systems by Boston, Philadelphia and American stock exchanges, and the International Securities Exchange. Under the new trading systems these exchanges can derive the advantage of more-level trading field as created by the Regulation NMS. On similar grounds in the European context the MiFID might bring a new European Alternative Trading Systems (ATS) in the near future. All these actions and efforts point towards an interesting and eventful short term future in the stock exchange structures, systems and operating procedures.

11. 0 Conclusion:

From the foregoing discussions it can be concluded that though there are potential dangers of the global consolidation of the exchanges it seems that the eventuality of the exchanges getting close together appears to be inevitable despite the roadblock being created by the regulatory measures. One can not undermine the potential threats the consolidated exchanges may pose to the development of the various economies. Globalizationin trade and industrial activities are to be looked into in a different way than that of the global consolidation of exchanges. In the former the governments have the ability to apply regulatory measures and control the developments. But in the case of global consolidation if the regulations are applied the consolidation may not produce the desired advantages. But the experience so far is the consolidation between exchanges of European and in between the exchanges within the United States Much remain to be seen when a real global consolidation takes place between an exchanges in the developed nation with an exchange in an emerging economy.

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