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EXCHANGES CHANGING – IS SPECIALISATION THE FUTURE?

Naufal Kerk, Head of Finance, Spectrum Markets

The fact that regulation and technology have turned many capital market areas upside down is not new. And if there was a measure of the degree of disruption in an industry, the segment of market operators would definitely rank high. We asked **Naufal Kerk, Head of Finance at Spectrum Markets,** about the fragmentation into different types of trading venues, how it happened and where he thinks the industry is heading.

Can you give us a quick run through the history of the stock market?

The Amsterdam Stock Exchange, which began trading in 1612, is considered to be the first stock exchange in the sense of a trading venue on which dividend-bearing shares can be traded permanently. The first stock exchanges are probably much older, but since these were commodity exchanges, it is difficult to say when they first became stock exchanges in the proper sense, as opposed to markets or trade fairs. Since then, exchanges have been established either as member organisations, mostly owned by the brokers trading there, or as state institutions. The change towards private and purely profit-oriented market operators, the shares of whom can be traded themselves, only began in the mid-1990s. There have been a number of investments, takeovers and spin-offs ever since, with increasing specialisation in the products and services that were once all brought together under the umbrella of one exchange per country or region. The main service was, and still is, the provision of trading operations. Transaction fees charged to their customers have thus long been one of the main sources of income for exchanges. There are also fees for admitting a security or company to trading. With the increasing importance of stock exchanges and the size of the markets, market data and the index business have also become increasingly important. In principle, this has not changed from the days of floor trading to the present day. But what has changed is the technical nature of infrastructures, data streams and data diversity as well as a completely different competitive situation compared to before.

By "before" you refer to the era prior to MiFID[1], right?

Exactly. For the first time, MiFID I formed a uniform European legal framework for the provision of investment services from brokerage to advice, trade execution, portfolio management and the issuance business. However, with the aim of promoting the integration, competitiveness and efficiency of the EU financial markets, the powers and responsibilities of national supervisory authorities was revised, too. Among other things, it was stipulated that member states can no longer require that all trading in financial instruments takes place on traditional stock exchanges. Until then, there was de-facto no European stock trading, shares of corporates were largely traded on the national market of the relevant corporate's residence. Of course, the directive also opened up the market for the EU-wide provision of other investment services, provided that sufficient organisational requirements were met. In conjunction with the introduction of MTFs[2] and systematic internalisers, however, the abolition of the concentration rule was one of the most effective measures under MiFID I, as it significantly increased competition both between stock exchanges and over-the-counter execution places. However, this came with side effects undesirable from a European supervisory perspective.

What were these?

In this context, one should recall the objectives of MiFID II. The revised version of the directive, which effectively came into force eleven years after the original version. These objectives were to increase the efficiency, resilience and integrity of the financial markets through a higher degree of investor protection, greater transparency and more competition. Some insights can be derived from this general overview: for example, the increased competition aimed at by MiFID I did not benefit all market participants equally. In addition, the market fragmentation caused by MiFID I led to an increased complexity of the trading environment and did not exactly reduce the deficits of the supervisory authorities in the collection of market and trading data. I'm not thinking so much about the financial crisis of 2008/2009, which was a major influence on MiFID II, but which was essentially about a combination of liquidity and own funds deficits, high derivative exposures and inadequate risk management. And this is where MiFID II has certainly set standards in terms of transparency. I am referring more to the relationship between on-exchange and over-the-counter trading: while European financial market regulation would like to see much more trading volume to be executed on-venue, it has not been lastingly successful so far.

Exchanges have lost ground in the IPO business, too.

From an earnings perspective, this is a problem for the ECM[3] business of banks, but of course also for the stock exchanges themselves, which become less important when both the number and volume of listings decrease. Particularly, small and medium-sized, growth-oriented companies are becoming increasingly reluctant to raise capital through IPOs. There are a number of reasons for this, one of which is that such a step is still relatively expensive for these companies to prepare for. In addition, investor demand for these stocks has fallen significantly. Many associate this with the rather wild years around the turn of the millennium when the bursting of the Internet bubble scared off many investors. While this is not wrong, it is only part of the picture. The Internet enabled many people to actively invest for the first time, as pricing, market activity and placing orders was no longer a tedious process of consulting a newspaper's quotes section and visiting a bank branch. Opening up a trading account with an online broker or bank was all it took to get started. Many of these early investors left the stock markets forever after the boom ended, but many have come back. Then again, many consider it to be much more efficient and less risky to invest only in funds, and predominantly in passively managed ones, because technological advances in terms of data usage and execution efficiency have also been significant for those who set up ETFs and similar vehicles. Another technology-driven development in favour of large and highly liquid stocks concerns algorithmic and high-frequency trading. As a result of these developments, demand for trading shares in small and medium-sized companies has declined significantly.

How can trading venues actively oppose these trends?

The aforementioned trend towards inorganic growth has been observable among the main market operators for a long time, with large mergers and takeovers becoming increasingly difficult. In addition, these companies still dispose of substantial sources of income. It must be mentioned, too, that regulation doesn't just create a burden: new opportunities arise in the course its implementation. Trade repositories for the reports under EMIR[4] and the SFTR[5], the services related to transaction reporting or publication services, are examples for where new niches have emerged for the major exchanges. For smaller trading venues, specialisation will have to be the strategy. We have embarked on a course that puts a clear focus on the retail investor – be it regarding the product offering tailored to exactly this investor category, the conditions under which brokers affiliated with us can enable their retail investors to trade or the features retail investors enjoy when their trades get executed on Spectrum Markets. This includes, for example, liquid trading 24 hours a day, five days a week. Furthermore, affiliated brokers are not charged any transaction fees, which should result in lower costs on the investor side. In total, the retail investor not only benefits from the transparency and security of a regulated trading venue, but also from a trading experience that is in no way inferior to a professional trading environment.

Thank you very much!

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[1] Directive 2004/39/EG (MiFID I) referred to as Markets in Financial Instruments Directive and revised to Directive 2014/65/EU (MiFID II)
[2] Multilateral Trading Facility
[3] Equity Capital Markets
[4] Regulation (EU) No 648/2012, the European Markets Infrastructure Regulation
[5] Regulation (EU) 2015/2365, the Securities Financing Transactions Regulation

today to discuss how the seamless market access that our venue provides, can help to grow your retail client business.

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