

MARKET STRUCTURE ANALYSIS

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Eight is Enough: Market Structure Predictions for 2008

As we sound the closing bell for 2007, below are eight market structure predictions for the new year, followed by a review of hits and misses from last year's list.

1. Equities Exchanges: Market Share Trench Warfare. By summer, NYSE removes the last pro-Floor advantages from Hybrid, automating the open and close and rolling out reserve order functionality to all participants. As specialists are replaced with "designated market makers" who can take an unconstrained, Nasdaq-style approach to producing liquidity, the differences between the major exchanges—not to mention ECN competitors BATS and DirectEdge—drop from slim to none. Pricing remains as a competitive lever, and new NYSE management isn't afraid to turn the dial. The flurry of price changes in the waning days of 2007 serves as a template. Market share becomes harder to move, however, as all major marketplaces are willing to go the mattresses. In NYSE names, NYSE Group holds 50% share, with ARCA accounting for more than half. Nasdaq's NYSE-listed share grinds upwards to 25%. (Nasdaq does better if NYSE makes the mistake of offering its new-breed specialists "parity" with the limit order book, thereby driving competing liquidity providers to fairer pastures.) In Nasdaq names, Nasdaq holds its current 45 – 50% share as the 3-way race for second place intensifies. Market data revenue-rich Amex names emerge as a battleground, again with price as the primary weapon.

2. Volume and Volatility Persist. As the past few years of easy credit recede further into memory, the equity market volatility of the last five months of 2007 proves the rule, not the exception, in 2008. While the herd is culled in some short volatility strategies, such as quantitative long-short, others pick up the torch. The heavy volumes of the last five months persist. In a "harder" market to trade, assumptions about execution workflow are questioned, leading to better order flow segmentation and more intelligent choices about how to use technology-driven tools. In a trading landscape evocative of the futuristic scenes in the first *Terminator*, the role of human judgment catches a small bid.

3. DirectEdge Graduates from ECN to Exchange, BATS Doesn't. After wiping the mat with the regional exchanges in the race to provide alternatives to the NYSE-Nasdaq "duopoly," DirectEdge and BATS pursue different approaches to achieve exchange status—and therefore improved economics and independence. DirectEdge merges with an existing exchange: either CHX or NSX (dark horse Amex would be the bold stroke). BATS goes it alone with its application to create a new exchange. Although its market structure isn't contentious, a three-commissioner SEC and stringent governance requirements keep BATS in the ECN bin for the time being.

4. NYSE Buys BIDS. Similar to ECNs in 1999, dark pool hysteria yields to consolidation, with exchanges as catalysts. NYSE—home of substantial, if waning, latent liquidity—takes the lead by moving past its proposed JV to an outright purchase of BIDS Trading. The negotiation features of BIDS prove powerful in combination with NYSE's neutrality and vast network, creating a "sell-side Liquidnet" at a price point that's tough to beat. Others pursue successful dark strategies—think ARCA's MPL order and Nasdaq's continuous crossing, which launches in the first quarter—and further combinations are bandied about (Nasdaq for Pipeline?). But NYSE-BIDS spurs the rationalization of the dark pool tangle via consolidation by low-cost exchange providers. Tiring of complexity, the industry welcomes this trend.

5. Amex and Nymex Trade. After much expectation, both Amex and Nymex are sold. The proximate cause for the first print is Nasdaq's garish \$652 million purchase of Phlx, and the protracted inability of Amex to execute on its own. With exchange licenses increasingly scarce and Amex bleeding options market share, it's no longer viable as an independent, and its assets are interesting at the right price. Deal speculation has surrounded Nymex since it became a public company, but suitors have been dissuaded by valuation and the unresolved issue of trading permit holder claims on revenues post-electronification. NYSE is the logical acquirer—energy derivatives would further diversify its business, General Atlantic is an anchor investor in both companies, and it's got floor space to spare—but the process takes longer than most expect.

6. Options and Equities Aren't "Different." As the penny pilot expands to cover 50%+ of options volume (March) and Nasdaq launches a new marketplace featuring a "pennies everywhere" hidden order (late first quarter), the thesis that "options are different" (from equities) looks increasingly suspect. Markets with "maker-taker" pricing—rebates for adding and charges for removing liquidity—continue to grow, accounting for 40% of equity options volume at year's end. High-frequency, quant-based market making strategies contribute to this trend, as do institutional investors, who gain comfort with volatility as an investible asset. The SEC extends Rule 605—execution quality disclosure—to cover options trading. Calls for an options TRF to facilitate dark pools and internalization are heard, but not yet answered. A schedule for permanent adoption of pennies for all options below \$3 is established for 2009 implementation—but Nasdaq's aforementioned hidden orders serve to make pennies a competitive reality ahead of regulatory change.

7. Futures Exchanges: A Credit Beachhead in OTC Territory. If 2007 was marked by a number of broker-lead efforts to constrain exchanges—think DirectEdge, Projects Turquoise and Boat, and oddities such as single-broker private equity markets—2008 witnesses exchange push back. With big banks reeling from write downs, futures exchanges redouble efforts to bring sorely-needed transparent pricing, anonymous trading, and multilateral clearing to credit markets. While the banks resist these incursions against the OTC market for obvious reasons, their hedge fund clients are more amenable. CME is a leader in this effort, along with ICE (which increasingly eyes financial futures opportunities) and Deutsche Borse (via ISE for U.S. products).

8. SEC-CFTC Merger Gets Push, But Stays on Docket. With international regulatory co-operation in the air (securities markets, anyway!) and an increasing sense that the U.S. should adopt a single, principles-based regulator for both equities and futures, the concept of a SEC-CFTC merger gains currency. While a good idea in principle (pun alert), the jurisdictional divide proves impossible to breach, as neither regulated constituency proves agreeable to changes in the status quo. Instead of working to resolve the issue before the election, the financial industry bears the political risks of kicking the question down the road. (And you thought subprime exposure was unhedgable!)

2007 Scorecard. As with 2006, we were right on five, wrong on two, and pushed on one. Clearly, listed and Nasdaq trading have converged and our exchange market share predictions came close (we did give ARCA too much of NYSE Group's 55% share). BATS and DirectEdge produced plenty of heartburn for incumbent exchanges, and two new independent dark pool launches—Level and BIDS—have introduced price pressure and close 2007 within striking range of the legacy pack. Reg NMS proved a non-event—except for the compliance costs and consultant punditry—and the industry bid a happy adieu to the tick test for short sales. Nasdaq announced plans to acquire both BSE and Phlx, including clearing assets at both with which it can compete with NSCC.

We missed on both our merger calls, as neither a BATS/DirectEdge/NSX nor a CME/CBOT/CBOE trinity came to pass. (We don't see BATS and DirectEdge together anytime soon, but we'll defend our latter call as "early" given CME's August purchase of 12% of the CBOT member exercise rights into CBOE.) Given the ongoing contention over the success of penny pilot for options, we'll cop to a push. Spreads have narrowed substantially and ECN-ish models have taken share, but the volume evidence is mixed and payment for order flow is alive (if not entirely well).

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