

History is a good predictor of *market structures that work*
An editorial on competition in Europe

A couple of weeks ago I was quoted in the press as having said “I would encourage anyone at the LSE to look at the NYSE market share chart, it’s a good historical lesson.” I would like to go on record as saying that I wasn’t taking shots at the LSE, whom I have a great deal of respect for as a preeminent global exchange operator. My comment was actually based on market structure principles and the healthy evolution of monopolistic markets into competitive ones that ultimately benefit the user community.

Responding to my quote, the chief executive of the LSE submitted a letter to the editor of the *Financial Times* earlier this week. In her letter, Ms. Clara Furse understandably defended the LSE and explained how their move to demutualize early, along with early adoption of an electronic order book, differentiates the LSE from U.S. exchanges. It’s true that those early strategic moves put the LSE in a strong position as competition started arriving, maybe even more so than was the case for U.S. exchanges at the time.

Ms. Furse suggested in the letter that the long held mutualization of NYSE and quasi-mutualization of Nasdaq is what kept their historic market share dominance in place and kept them from “making important strategic investments for the benefit of the market as a whole”. She also theorized that the NYSE and Nasdaq transitions into for-profit entities were a result of intervention by U.S. regulators who “continue to prescribe strong medicine today”.

It is our belief that what kept two major markets in their dominant positions in the U.S. was a regulatory framework that didn’t support competition, at the time, as broadly as it does today. The SEC didn’t direct the NYSE or Nasdaq to become public companies. Instead the SEC has been developing a regulatory framework, for several years, that enables competition and opens the door for new entrants. Moving to for-profit status was NYSE and Nasdaq’s choice as a way to remain competitive in the evolving regulatory framework.

Similar efforts are currently underway as the FSA and other European regulators roll out and support the new MiFID framework. This framework for competition is just now being built and bolstered in London and the rest of Europe. New entrants are popping up everywhere. Some will fail, some will prosper, and some will acquire and/or be acquired. That’s the nature of competition. *Regulatory support for competition* is the force that brought about a reshuffling of market share in the U.S., not corporate structure, and it’s likely that it will happen in Europe and other regions around the world much the same.

In the letter defending the LSE’s current position, an important point was left out. The LSE technology, management, and market model might be exactly the right combination *for the LSE*, but what *the securities industry requires*, in Europe and elsewhere globally, is *viable* competition. Just today, the FT published an editorial expounding on the need for alternatives to the LSE. The trading community needs alternative trading platforms, and for many good reasons. No matter how good any one market center is, a lack of viable competition can put the wider industry at risk.

Why is competition good for an industry? There are a few key points relevant to the securities industry that are worth highlighting.

First is efficiency. Efficiency comes in many forms, but in essence refers to how much work can be done for as little cost as possible. This often takes the form of reduced prices for consumers. This is already happening in Europe as new entrants are offering new price models and reduced fees for trading on their markets, and incumbent exchanges are rethinking their pricing models and making fee adjustments as well.

Second is resiliency. We are sympathetic towards the LSE for having suffered an outage earlier this week. In a world in which technology is at the core of nearly everything we do, outages are a fact of life for all market centers. Some of the outages in our industry aren't even foreseeable or preventable. Nobody is immune, BATS included, despite the immense investment that we all make in Disaster Recovery and Business Continuity plans. What is unfortunate is that the recent LSE outage impacted a large portion of the greater U.K. securities industry as well. This was the primary focus of today's editorial in the FT.

How did the London market get into this situation? It was due to legacy market structure and a regulatory framework that enabled a monopoly to exist. As a result, the local market became dependent on a single platform to conduct its daily business. Many people are wondering why most U.K. firms pulled back their trading activity across all local market platforms during the outage, even though there are currently alternative MTF's actively running.

Pulling back may have been the best response given the minimal levels of cross-linkages between firms and alternative market centers that have been implemented thus far. It's early days yet, but moves by the FSA to support and encourage competition are laying the foundation for long term improvements.

The only true resiliency in a given industry comes from viable alternative competitors, who are each trying to solve the same industry problems in different ways. It won't happen overnight. It will take time for the European trading community to make their connections to alternative platforms and to trust price discovery that comes from competing market centers, but eventually it will work. Eventually all the markets will be connected to each other, one way or another. Eventually traders won't live in fear that a single market's system failure can cause trading to halt for the whole country.

Third is innovation. In a competitive market place, new services and opportunities available to the user community can grow at exponential rates. New ideas are tried and tested, and improvements are made on existing solutions. Systems get faster and learn to handle ever increasing loads. Competition simply makes each firm better than they would be alone.

Currently, some European incumbent exchanges operate platforms with the capacity to handle message traffic upwards of 10,000 to 20,000 messages per second. Competitors starting up in Europe over the coming months, BATS included, have systems currently capable of handling trading activity well in excess of 100,000 to 200,000 messages per second. Even under these heavy volume loads, the BATS platform can turn orders around in microseconds (1/1,000,000 of

a second). Most incumbents still measure their response times in milliseconds (1/1,000 of a second). Order routing between markets, dark pool integration, new order types, clearing efficiencies, and experimental pricing models are additional examples of the improvements that competitive innovation can bring to the industry. I expect incumbent exchanges will respond after new entrants gain market share and will push up their own capabilities as well.

These, and many others reasons, are why European markets will benefit from heightened competition. These are the reasons why market share is going to shift and move. We agree with Ms. Furse that the overall pie will grow, and we agree with the *Financial Times* that no one single market should be allowed to carry an overreaching and dominant position.

Only those markets that remain nimble and competitive will be a part of the new landscape, and we are betting that the LSE will certainly be one of those who survive. We doubt, though, that they will maintain their currently dominant share of the pie when the dust settles, and that's why I suggested that recent developments in the U.S. would be a good historical lesson. Not only for the securities industry in Europe, but for any industry where regulators are actively supporting and encouraging competition.

We are likely to be reaching new European readers with this edition, so please let us know if you, or somebody you know, would like to be added to our distribution list for future newsletters.

Sincerely,

Joe Ratterman
Chairman, President and CEO
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