SIX in a sea of change

PHOTO: NEWS SERVICE

The world of stock exchanges is consolidating fast. Switzerland looks like an island of calm in the middle of a sea of mega-mergers. This calm hides either a terrible situation or a clever positioning

BY CYRIL DEMARIA

Stock exchanges are businesses like any other. This is the striking conclusion coming to mind after the gigantic wave of mergers and acquisitions that has spread over the course of the last ten years. “The logic of these mergers is to address the globalisation of their clients’ trading activities”, explains Bruno Lemière, president of Arche Informatique, which specialises in advising stock exchanges. The target of these mergers is to generate economies of scale, to mutualise costs and to standardise offers.

As a result, Euronext was created in 2000 through the merger of the Paris, Brussels, Amsterdam (and later Lisbon) stock exchanges. It acquired the Liffe in London, before eventually merging with the NYSE. This group is currently being acquired by the Deutsche Börse (DBAG) in a USD 25 billion deal which would create the largest stock exchange in the world.

Meanwhile in 2008, the Nasdaq merged with OMX (which gathers the stock exchanges of Stockholm, Copenhagen, Helsinki, Reykjavik, Tallin, Riga and Vilnius). The London Stock Exchange (LSE) acquired its Milanese counterpart and is currently merging with the Toronto-Montreal exchange (TMX). The Tokyo and Osaka exchanges have announced their merger project, while Singapore tried unsuccessfully to acquire the Australian Stock Exchange (ASX).

The InterContinentalExchange (ICE) and the Chicago Mercantile Exchange (CME) are also planning some movements, even though unclear at the moment. The CME acquired the Chicago Board of Trade (CBOT) in 2007 and then the Nymex. The NYSE Euronext – DBAG tie-up would menace the dominance of the CME on derivatives and clearing (and generate an estimated EUR 100 million of revenue synergies for the new group in that area).

ICE and Nasdaq-OMX unsuccessfully made a hostile counter-offer to the planned acquisition of NYSE-Euronext by DBAG. Should this plan fail, Nasdaq-OMX could target other acquisitions such as the Chicago Board Options Exchange (CBOE); and even go as far putting itself up for sale to avoid marginalisation. Another option could be an LSE-TMX and Nasdaq-OMX merger.

The ICE could be a potential acquirer, but Nasdaq is essentially positioned on a razor-thin margin business of stock trading. That makes it a rather unappealing target. The prospect is even less attractive when considering the entrance of the multilateral trading network BATS (which has recently merged with Chi-X) on the US stock trading business this year. As a matter of fact, “stock exchanges have faced an increasing pressure on costs from their

SIX GROUP KEY FINANCIAL DATA (2009-2010)

	2009		2010		2009/2010
	in CHF thousands	%	in CHF thousands	%	Change %
		100.00	1,523,270	100.00	+2.68
Turnover	1,483,384	14.93	216,948	14.24	-2.07
Trading	221,549	15.50	244,532	16.05	+6.30
Services and clearing	230,034	28.03	394,118	25.87	-5.22
Financial information	415,836	41.52	667,672	43.83	+8.39
Payment processing	615,965				
		84.46	1,220,492	80.12	-2.58
EBIT (Group)	1,252,885	14.85	173,588	11.39	-21.19
Net result	220,289				

SOURCE: SIX, AUTHOR

clients", states Bruno Lemière. BATS will further increase this pressure on stock trading prices for Nasdaq and the NYSE.

A more attractive prospect lies in the fact that the Singapore stock exchange uses the Nasdaq-OMX technology. NYSE Euronext has already reached an agreement with the Tokyo Stock Exchange (TSE) to ease the trades between the two platforms. The synergies between the Asian group and the American-European stock exchange might justify a move.

Big fish in a small pond, small fish in a big pond

In fact, technology was one of the reasons why Nasdaq merged with OMX in the first instance. The NYSE Euronext – TSE deal is partly fuelled by the fact that TSE uses the Liffe Connect technology for its options trading platform. Liffe Connect is to be replaced by Eurex (owned by DBAG), should the merger be approved. As a technology provider, Nasdaq-OMX is one the leading worldwide companies of the sector – just like the Swiss Stock Exchange (SIX). Technology is indeed crucial, as SIX has seen its average market share in Swiss blue-chip stocks dropping from 84.9% in 2009 to 70.6% in 2010, due to the competition of multilateral trading networks (MTN).

The main sources of growth for stock exchanges today are services associated with stock trading, such as derivatives and clearing revenues (17% of Nasdaq revenue, 33% of NYSE Euronext, 40% of Deutsche Börse in 2010). To face its decline in stock trading, the SIX Group has been increasingly focusing on financial service payments, distribution of information and post-trade services (i.e. clearing). According to its 2010 financial statements (see Key Financial Data), the Group generated respectively 44%, 26% and 16% of its turnover in these areas.

This means that SIX Group is closer to a Visa or Mastercard than actually the other stock exchanges. SIX diversified its risk out of stock exchange-related activities by targeting credit card processing and other IT services. It is exposed to the consumer market trend, which is quite a stretch for an operator of a financial marketplace. Worryingly, its financial information division has suffered even more than its trading activity last year.

How SIX will handle its need to ramp up its activity in derivatives (which are booming) remains a mystery. Four American banks – JP Morgan, Goldman Sachs, Bank of America and Citi – dominate 95% of the market, according to a 2011 report of the US Office of the Comptroller of the Currency. So far, SIX is linked in a joint-venture with DBAG through Eurex, Scoach and Stoxx, which means that the future of this business is clouded by the merger efforts. SIX has been notably silent in the middle of the merger storm, except to reaffirm its will to remain independent. The Swiss Group is privately owned by 160 financial institutions, which relieves part of the pressure towards a merger. It declined our interview request.

The SIX Group strategy seems to be made valid by the market, so far. "Indeed, the other role of financial marketplaces is to address local needs: initial public offerings, collecting and transmitting financial information, collecting investments and providing services – all of which are currently offered by SIX Group and are well placed in the market to increase its competitive advantage", analyses Bruno Lemière. That is if the regulator allows SIX to operate with such a strategy – and by regulator, reference is not made to the Swiss Finma, but the real one in that case: the European authority.

SIX has developed an approach based on the delivery of a quality label as the equivalent of a trusted third party. Even if it suffers sometimes from hiccups, like the IPO of the ill-fated Transocean, the Swiss quality label proved to be a strong advan-

IMAGE: ISTOCKPHOTO

MAIN STOCK MARKETS' SIGNIFICANCE IN THE NATIONAL ECONOMY (2008)
In USD billions

Exchange	GDP	Domestic market capitalisation	%
Americas			
BM&FBOVESPA	1 572,8	592,0	37,6%
Mexican Exchange	1 088,1	234,1	21,5%
NASDAQ OMX	14 441,4	2 249,0	15,6%
NYSE Euronext (US)	14 441,4	9 208,9	63,8%
TSX Group	1 499,6	1 033,4	68,9%
Asia - Pacific			
Australian SE	1 013,5	683,9	67,5%
Bombay SE	1 206,7	647,2	53,6%
Hong Kong Exchanges	215,4	1 328,8	617,0%
Korea Exchange	929,1	470,8	50,7%
National Stock Exchange India	1 206,7	600,3	49,7%
Osaka SE	4 910,7	147,4	3,0%
Shanghai SE	4 327,4	1 425,4	32,9%
Shenzhen SE	4 327,4	353,4	8,2%
Singapore Exchange	181,9	265,0	145,6%
Taiwan SE Corp.	391,4	356,7	91,1%
Tokyo SE	4 910,7	3 115,8	63,4%
Europe - Africa - Middle East			
BME Spanish Exchanges	1 602,0	948,4	59,2%
Borsa Italiana	2 313,9	522,1	22,6%
Deutsche Börse	3 673,1	1 110,6	30,2%
London SE	2 680,0	1 868,2	69,7%
Luxembourg SE	55,0	66,6	121,2%
NASDAQ OMX Nordic Exchange	1 212,5	563,1	46,4%
NYSE Euronext (Europe)	4 494,7	2 101,7	46,8%
SIX Swiss Exchange	500,3	880,3	176,0%

SOURCE: WFE

tage. As stated by Bruno Lemière, "its vertical offer is a strong advantage. Thanks to its comprehensive integrated offer of services, SIX has no pressure to merge with another actor."

However, the SIX Group independence is a double-edged blessing. First, because SIX declares that one third of its turnover is already generated abroad, through its 23 operations (notably in Paris, London and Stamford). This exposes SIX to the indirect impact of regulatory changes on its clients without the legal clout that a truly international weight can provide.

Regulatory rodeo

A clear example is the declaration from the EU competition commissioner Joaquin Almunia that he had doubts about the "vertical silo" model adopted by the successful industry giants. This refers to the joint practice of controlling and clearing the trade of securities. In fact, the EU legislation, which has precipitated the M&A wave, was targeting this "verticalisation" of stock exchanges to try to generate competition. The market backlash to this regulation, and among them the dreaded MiFiD (Markets in Financial Instruments Directive), has rushed the cre-ation of quasi-monopolies and the boom of unregulated exchanges (dark pools and over-the-counter, or OTC). The European regulator now wants to include OTC and derivatives in the regulation scope.

For that reason the EU is looking closely at the NYSE Euronext – DBAG proposed merger. The LSE-TMX deal is under strong scrutiny as well. The lobbying will be intense both for and against these mergers, but SIX Group will be kept out of the debates. However, it will have to accept the consequences of the decision, which will notably apply to its key partner: the Deutsche Börse.

What would be the alternative to these silos? The EU preaches the inter-operability of the platforms, but this has already led to the fast commoditisation of stock trading and the subsequent merger wave. Banks complain that vertical silos prevent a healthy competition between stock exchanges, and hence maintain prices artificially high. However, banks themselves are managing dark pools (type of trading platform that allows large blocks of shares to be traded without the prices being revealed publicly until after trades are completed), which are competing with stock exchanges – and escape the regulation applying to the latter.

SIX Group does not have conflicts of interest with its clients, which is a strength in the current debate. However, mergers of its competitors could squeeze its technical solutions out of certain markets. So far, the Swiss financial marketplace has managed to cleverly organise its strategic partnerships to balance independance and international reach. It will have to do better to attract an increased share of international IPOs (on which it competes with Hong Kong and Singapore) and derivatives.

This would however pose another risk, which would be systemic, as the market capitalisation of groups listed on SIX (see Main stock markets' significance in the national economy) are already 176% of the GDP. Bad derivatives management contracts have sent the American insurance group AIG into receivership in 2008, prompting the intervention of the US Government to salvage it. Does Switzerland want to deal with bad derivatives-management consequences going forward?