

Progressing Financial Markets

PFM01 – Setting The Scene

With Lee Hodgkinson, CEO, SWX Europe

Mike O'Hara: [0:01] Voices in Business presents: Progressing Financial Markets, a podcast sponsored by IBM.

[0:06] Episode 1: “Setting the Scene” with Lee Hodgkinson, CEO of SWX Europe.

[0:12] [music]

Mike: [0:18] Well, hello, and welcome to the first episode of Progressing Financial Markets, a brand new podcast series brought to you by Voices in Business and sponsored by IBM.

[0:28] Throughout this series, we will be talking to a range of thought leaders in the banking and financial services industry to get their take on how the industry is changing and how they are facing up to the challenges of these increasingly uncertain times.

[0:40] We will be covering a wide range of issues, including how risk is continually evolving, the proliferation of data, the changing landscape of regulation, and the onward march of technology and its impact across the financial market spectrum, with a particular focus on how the competitive landscape and client behavior itself is changing.

[0:57] My name is Mike O'Hara of Voices in Business and I will be co-hosting this series with Keith Saxton and Suzanne Duncan of IBM, who will be asking our guests hopefully some incisive and searching questions.

[1:08] Keith Saxton is the global director of Financial Markets at IBM. An industry veteran, Keith originally spent 18 years in the City, where he headed Fixed Income Trading at Deutsche Bank, IBJ International, and Scotia Capital Markets before joining IBM in 1998. In his current role, Keith is overall responsible for strategic growth opportunities within financial markets.

[1:28] Good afternoon Keith.

Keith Saxton: [1:28] Hello.

Mike: [1:30] Suzanne Duncan is Financial Markets Industry Leader at IBM's Institute for Business Value. Before joining IBM in the year 2000, Suzanne headed institutional sales at State Street Global Advisors. Suzanne joins us on the line from Boston. We are a few hours ahead of you Suzanne. Good morning.

Suzanne Duncan: [1:45] Good afternoon.

Mike: [1:46] I am very pleased to welcome as our featured guest on this first episode, Lee Hodgkinson, CEO of SWX Europe, the London-based recognized investment exchange that was founded in 2001 as the first cross border trading platform for Pan-European blue chips. Lee joined the company when it was founded in 2001 and led the developments of SWX's high capacity transaction platform.

[2:08] Lee, good afternoon and welcome.

Lee Hodgkinson: [2:10] Thank you.

Mike: [2:11] Keith, over to you.

Keith: [2:13] Mike, thank you for that introduction and Lee welcome. So, based on a number of recent interviews within the industry, we are seeing executives change their focus due to the current economic climate. How do you see this current market turmoil playing out, and has that resulted to any change to your own strategic initiatives?

Lee: [2:30] That is a great question. Mark Twain had a fantastic quote where he said "History doesn't repeat itself, but it does rhyme." So, I think, in this current crisis, if we want to use some kind of tabloid language to frame it in, it does feel, in some respects, like a place we have been to before. But, in other respects, it feels very different and there are some known unknowns and some unknown unknowns.

[3:05] Perhaps we have not had such a kind of liquidity crunch before certainly for a very very long time. We have gone through periods, as recently in the US, in 2001, the dreaded "R" word - recession. So, a lot these things we know and understand in the UK, we had inflation and huge interest rate rises and all that kind of stuff around the ERM days. So, a lot of these things are familiar.

[3:29] I think, there are some unfamiliar things as well. A lot of the unfamiliarity, I think, is around Asia and the Middle East. So, really, when we have gone through economic downturns before, we haven't had oil, at not just a high price, but a price that I don't think anyone could have ever predicted, and depending on who you believe, on automatic pilot to the moon! And that has, of course, filled the coffers of the Middle Eastern nations, and others.

[4:01] I think that we have India and China as economic powerhouses, particularly China. Their destiny seems to be interdependent on the US; huge exports from China to the US paid for with US treasuries. So, I am not quite sure who needs who most. And the answer is, I think, in this globalized world, we all need each other as much as anyone else.

[4:28] But, we are kind of left with a position where, interestingly, the sovereign wealth funds of Asia and the Middle East may actually end up bailing out the West. In the past, we've been talking about the Asian crisis or the Russian Crisis. Well, perhaps we will be talking, in the future, about the Western crisis. And I think, it is interesting to ponder

whether this will be the inflection point that marks the genuine rise of the East, if you like. So, it is fascinating.

[5:01] I was in Hong Kong recently and it didn't feel like a depressed place to me. It felt like a pretty buoyant place with everybody talking about expansion and growth and things that we would dare not speak about in the West. So, very very interesting time.

[5:19] I think, we are also still in that phase where it's too early to predict what the outcome will be, because for every article that says "I have just seen some data that means we are turning the corner," there will be another bit of data that says "Actually, we are still in a bit of trouble." I think, Washington Mutual and Merrill Lynch are probably the latest examples of that. I am sure there is more to come and there will be some ups and downs, but the world is definitely changing.

[5:51] So, how it is going to turn out, I would suggest that this marks the rise of Asia and the Middle East, but we might not realize it for perhaps even another generation. But, interesting times.

[6:05] Has this situation resulted in a change to my own strategic initiatives? Not yet. We are still pressing ahead with our program of transformation, and I see that as a business imperative, because our own industry is commoditizing and under tremendous pressure.

[6:28] I remember Suzanne's paper, "The Trader is Dead. Long Live the Trader." I think, many of those things that were predicted in that paper are now playing themselves out. The meteoric rise of hedge funds and their aggressive use of direct market access and algorithmic trading, the gargantuan growth of capacity and reductions in latency, the intelligence of computing, deregulation; I don't think there is a single facet of our business that isn't undergoing fundamental and long lasting change. However difficult it is to balance the priorities and cut costs and find money at the same time and simultaneously expand and contract, if that makes sense, we are going to have to find ways to do that.

[7:18] So far, we don't have any plans to change our strategy. I think that we do have to be very mindful of cost control and perhaps focus a little bit more on prioritizing IT investment dollars.

[7:34] But, the demand in Europe from our customers for change is substantial. And I think, we hear a lot of views of people saying that the US budgets for infrastructure expenditure in those banks have been pushed to Europe as people try to find avenues for growth. And I think, Europe is a little bit more adjacent as a venue to America, rather than Asia, which is really many Asias, I think.

[8:01] So, we see a lot of change, a lot of demand - right now, not much slowdown in anything in our business. So, if the crisis continues, we might see some of the new, low-cost rivals that are coming into the business finding a little harder to get funding in the second round. But, certainly, in the near term, it's all systems go.

[8:28] Largest challenges, as I say, I think are finding ways to continue to expand and meet the needs of our customers, create this perpetual dissatisfaction with the status quo, whilst making sure that our cost bases are gradually reducing. Because, essentially, the new, low-cost rivals are challenging the prevailing economics of the business. And in these conditions, of course, cost awareness is on everybody's mind.

Keith: [8:59] OK. Very good. So, staying on the theme of change, would you agree with the view that we're in the midst of a significant shift in the way the market interacts - a shift that has been led by technology? You have been quoted before as saying that this is a perfect storm for exchanges. Has your view changed on that anytime over the last six months?

Lee: [9:17] No. It hasn't changed at all. In fact, I think, we're getting closer to the eye of the storm. So, we have Turquoise launching very soon. Chi-X is starting to show some progress. The other new venues are coming in behind them.

[9:33] And I just think that if you look back only a few years ago, volumes were nowhere near what they are today. And primarily that's because the technology that has enabled them and the use of derivatives that has driven them, that just wasn't around. I mean, it just wasn't possible to talk about trading four times in half a millisecond, and those firms that were thinking about it had enormous budgets and rocket scientists. And now, all of that stuff is commoditizing, and everybody's got it or are in the process of getting it. So, I don't see it changing.

[10:14] In fact, I think, we are heading for an increased period of upheaval. But, I do expect it, like all great storms, to be followed by a period of calm, where I think there will come a point, particularly the participants will say, "OK. Hang on. We've invested in every bit of technology going. We're connected to every venue. Now, we need to make sure that we understand how we're going to make money out of all of this stuff and start working out which venues are giving us best value for money, best quality, and the most liquidity."

[10:48] So, I think 2009 has the potential to be more about stability, as people start really embedding these new technologies and systems into their kind of trading workflows.

[10:59] And again, if you look at the States, the contrary view is that hasn't happened. It's continued. The price wars have continued, and competition is really cutthroat over there. And it is hard to think that that won't happen in Europe.

[11:14] So, I believe, it's a perfect storm. I do tend to believe there will be a period of consolidation as things bed down and people start to understand how all this interacts, particularly in the dark-trading space. But, change is the name of the game at the moment. And it's not an option, I believe, for any of the players in the game to sit back and see how it plays out. You've got to take risks and put yourself at the forefront.

Mike: [11:43] Suzanne?

Suzanne: [11:44] So, just a couple questions for you, Lee. We are currently, in our research study, nicknamed C-Squared: one C for "client," one C for "competition." We're currently analyzing disruptive forces that are shaping the future of the competitive landscape within the financial markets industry.

[12:01] So, to name a few, we're digging into, of course, the credit crisis, which we've talked about. This actually ranked - no surprises here - as the number one response. Also, longer-term or evolutionary disruptive forces, such as shifts in wealth, which you mentioned earlier - the rise in power in Asia, and Middle East in particular. And so, shifts in wealth ranked as number two, just to name a few of these disruptive forces. Some are revolutionary, like the credit crisis. Some are evolutionary.

[12:30] So, with that as a backdrop, the question, Lee, is how do you believe the liquidity power is shifting within the industry - so, across the various industry participants, thinking about the buy-side, the sell side, exchanges, ATS's, among others? And you can also think through any possible new entrants or new extinctions.

[12:50] So, again, just to repeat: how do you believe liquidity power is shifting within the industry, across the various industry participants - the buy-side, the sell side, exchanges, ATS's, and any others that you may think of?

Lee: [13:03] How long have we got for this?

[13:04] [laughter]

Suzanne: [13:05] [laughing] This is a big one.

Lee: [13:07] Generally speaking, I think that the availability, ease of use, and low cost of cutting-edge technologies, for the buy-side, mean the power of liquidity and the economics of the industry are shifting to the buy-side. There's no doubt about that. And really, the vanguard of that change has been led by the hedge funds. But now, we're seeing many more of the, I guess, conventional buy-side taking up the charge. And I think, unbundling has made quite a big difference, in certain areas of the market - and in others, less so - but we're certainly seeing the shift in power to the buy-side.

[13:52] Now, the interesting thing about that is that, as the more conventional economics get challenged, the buy-side, I think, is starting to see that, in essence, they are not only getting more power, but they're actually getting more responsibility. And I'm not entirely sure that at this cycle in the industry, they're comfortable with that responsibility.

[14:20] So, it's actually relatively easy to give an order to a broker and say, "Look, you just take care of this. And by the way, because I'm such a huge, global, buy-side institution, I'm not going to pay you a lot of money for this." That's actually pretty powerful. The buy-side kind of get what they want, and it's low-cost.

[14:43] We're starting to hear that some of the big sell-side firms are basically saying, "Look, you're using self-directed flow through our DMA channels to such an extent that

our revenues are dropping such a large degree so quickly, we're not sure we can afford sell-side traders anymore." And that is playing to your report a few years ago, and that the sell-side traders, as you predicted, are now better at managing risk and trade ideas. But, I'm not sure you can just phone them up and say, "Look, here's an order. Go off and do it for next to nothing."

[15:19] So, we're starting to hear that some of the sell-side commissions for the more complex deals are actually starting to rise. And that would make sense. So, I think, the business model is changing. The buy-side isn't going to have it all their own way, but certainly the power is heading in that direction.

[15:40] I think, also, as with any transformational environment, there are some winners and losers, some early adopters, and some at the end of the tail. And not all of the big buy-side firms are investing huge amounts in technology, but I think, over time, they will. So, of the traditional players in the game, I think the buy-side look like long-term winners in the power stakes.

[16:08] I do like dark trading. Think about the venues. There's something very, very compelling about it because, whereas a lot of the venues...

[16:18] I mean, let's look at the statistical arbitrage business. Yes, you need low latency. Yes, you need high capacity. But, the margins that can be earned by everybody in that value chain are not particularly substantial. Whereas, in the dark space, you're helping a very high-quality business get done. You're solving problems. And I think, wherever you can solve problems and add considerable value to your client base, you're obviously able to charge premium rates.

[16:50] So, the idea that firms can cross large blocks of stock in the dark, at prices at or better than the touch on the public-displayed markets, I think, is a huge opportunity. And, in essence, we're seeing the automation of the upstairs market, in that sense.

[17:07] So, I think, we've seen a lot of growth in the US. We'll see further growth. And I subscribe to the prevailing wisdom, and I think the US will see 20 percent of equity business traded in the dark by the end of the decade.

Suzanne: [17:23] And Lee, just to pause you there, just a clarifying question. So, dark venues can take many different shapes and forms. So, thinking through, some of the largest internal crossing networks exist within, say, BGI, or within State Street Global Advisers. Others exist within buy-side to buy-side trading venues, like LiquidNet Pipeline. And some exist, of course, on the sell side. Are you considering all of the above in your statement about them being beneficial and helping a high-quality business get done?

Lee: [17:57] Yes, all of the above, I think.

[18:00] Now, what's important about dark trading, I think - and you raise a good point about the broker-sponsored venues - is that neutrality is going to be very important. So,

where business is not done in full view of the public limit order book or on the floor of the NYSE in the old days, but is crossed internally or in the dark or on one of these platforms, I think neutrality will be very important.

[18:27] And we're hearing a very strong message from the buy-side that they wish to see non-broker-sponsored venues. Broker-sponsored venues and internalization clearly has its place, no doubt about that. But, I think, the exchanges can expand their service boundaries by getting into that space. And we have done exactly that with NYFIX, who are one of the founders of neutral dark venues in the US. We'll be rolling that out in Europe.

[18:56] So, I am a very big fan of neutral dark venues. I think the disruptive participants will be successful in the short term.

[19:07] There are some questions around their long-term sustainability, I think - not just, as I mentioned earlier, around funding, which might be a little bit more difficult to achieve than in previous years, but also around differentiation.

[19:22] So, in Europe, we will see a number of new venues arrive in the next few months, all of which pretty much look the same. They all have very fast technology, lots of capacity, very cheap, and are designed for statistical arbitrage business. There's room for one and a me-too, but I'm not sure there's room for a me-three and a me-four. So, we might see an MTF war before we see an exchange war. And it'll be interesting to see, in Europe, whether we see the emergence of a kind of mega-MTF that then starts to compete more readily with the exchanges.

Suzanne: [20:02] Similar, I guess, you could argue, to what occurred in the United States.

Lee: [20:05] I think there's an evolutionary stage. There's the kind of, if you like, quasi-monopoly franchises of the old days, and we're leaving that behind - we left it behind in America; we're leaving that behind in Europe; I think it still exists in Asia to some extent - moving into the existing American-style business, where you have disruptive new entrants aggressively competing against the incumbent exchanges and winning up to 50 percent of the market share.

[20:34] And then, I think, there might be a third stage, a few years off, where essentially we have the big five or six global exchange franchises, who, just through sheer economies of scale, are able to dominate the landscape. But, again, around that, there will always be opportunities for niche players.

[20:54] So, the power bases are shifting, but longer-term winners, at the moment, look to me like the buy-side and the big, global exchanges.

Suzanne: [21:03] OK. So, a follow-up question to that. This is looking at it from a client point of view.

[21:11] When we asked the question in the interviews - and regardless of whether we're interviewing an asset manager or a broker dealer, we ask the question, "What keeps you up at night?" Some say, "My teenage child." [laughs] But, when those answer in earnest, what challenges them the most, they expressed anxiety over staying alive, of course, given the credit crisis, and that the top strategic priorities are two-fold. The first is mitigating risk, and the second is reducing cost. Kind of goes without saying, given this environment.

[21:41] So, the question is how can you and your organization, or how are you looking to help your clients address these strategic priorities and help them sleep better?

Lee: [21:52] That's a great question. It's a real strength of the exchange business model that, again, not only is it a regulated entity - we put a lot of effort into compliance and surveillance - but it's also a fully cleared business. All of the business in our market and many others goes through recognized clearinghouses. So, I think, there is, in the current infrastructure, a lot of systemic risk management there, and our firms benefit from that. I think, also, it's got a lot cheaper than it was five years ago, when we first launched the CCP.

[22:27] Secondly, I think, there are opportunities, although they're quite complex opportunities, for exchanges to start offering further exchange services and cleared services for OTC products, particularly in the credit products, there's a lot of opportunity for the exchanges to start to provide more risk-management services.

[22:51] I think, one of the issues is how do you standardize those products, and in many cases, it's like putting a square peg in a round hole so that there are some challenges there, but I think we do quite a good job of managing risk, and particularly those exchanges with derivative franchises are well placed to do that.

[23:14] Reducing costs - certainly, there are a couple of angles to this. Firstly, the kind of naked tariffs of exchanges are getting reduced. We reduced ours by 22% on the first of April, and I see a long term trend for reducing trading tariffs across the board I have to say.

[23:36] And that era of commoditization that you've seen in the U.S. and some of the statistics that NASDAQ and NYSE show about the erosions of their margins is pretty scary, but I think you will begin to see that in Europe.

[23:53] So, that'll contribute to a lower cost industry, and that's why competition is good. There's absolutely no doubt about that. But, I think, also the way that technology is rolled out and the kind of technical services that the exchange is now moving towards also help in reducing costs.

[24:11] So, I think, FIX has been a great example of how to remove costs from the industry through just completely demystifying the connectivity protocols. And so, there'll be a lot more work in that area.

[24:25] I think, there's some more to be done on harmonized regulation and again on the clearing front, which typically dominates all of the headlines, particularly in Europe, where we still have many CSDs, one for each country, many CCPs.

[24:40] And that is a debate that has gone a little quiet more recently, but is about to return with a vengeance because ultimately, having so many CSDs, whether they are in a vertical or a horizontal model or whatever, the very fact that you have to settle in so many places just inherently adds cost.

[25:03] And that's something that the industry will no longer be able to stand in the years ahead. Hence the arrival of DTCC from the States, also EMCF, which appears to be gaining some traction with Chi-X and NASDAQ and BATS, and firms like Citi and BNP starting to do a lot more as well.

[25:21] So, the incumbents have responded, and certainly many of them have, with the link up markets, a deal which is involved in ClearStream and SIS in Switzerland and in a number of other countries.

[25:35] So, there's got to be more progress in the back office area, where the costs are, I think, still high and have not been subject to the same competitive pressures as the front office costs to date.

Keith: [25:48] So, with all this current uncertainty, volatility, opportunity, what's your view on the ongoing impact of regulatory change? Perhaps the danger of over-regulation in response to the current crisis?

Lee: [26:02] I've learned a lot in the last 18 months, two years, about the laws of unintended consequences. Both with Reg NMS in the U.S. and MiFID, we've seen two well intentioned regulatory edicts that were specifically designed to increase transparency have very unintended consequences.

[26:27] The first which is applicable to both the U.S. and Europe is the rise of dark trading. So, I'm not quite sure how the regulators feel about putting out this legislation to improve transparency and consolidated tapes and all that good stuff, and then see it give rise to less transparent trading, albeit not necessarily to negative effect.

[26:49] In Europe, we've also seen the start of the rise of dark trading, but we've, again I think, because we don't have a consolidated tape under MiFID, seen a lot of confusion in both the collection and analysis of post-trade data. Neither of those outcomes were intended for MiFID. But, we are where we are, and the industry has to get used to them.

[27:16] So, I think a number of the more recent regulatory announcements that we've seen around speculation and the commodities markets being reined in, short selling of... I think in the U.S., quite a broad range of equities being prohibited, and also in the U.K., restrictions on short selling of rights issues, are understandable from a political standpoint. You know, from the "something has to be done".

[27:42] And they are well intentioned and have a great deal of sympathy with the people who are in that position to have to do something. But, I do think, we have to be very careful about the unintended consequences of what some of those developments will actually bring.

Keith: [28:01] Excellent, Lee. Thanks very much for your interesting points of view and for spending the time with us today. Thank you.

Lee: [28:06] Thank you.

Mike O'Hara: [28:07] Before we do wrap up, if listeners want to find out more about SWX Europe, a quick URL for your website?

Lee: [28:13] Yes – www.swxeurope.com.

Mike: [28:15] Excellent.

Lee: [28:17] And we'll have our core website, plus a brand new microsite on our dark trading service with NYFIX.

Mike: [28:23] Excellent. Well, thanks very much for that. Before we go, a quick word to our listening audience. If you enjoyed this program and would like to be automatically notified as and when new episodes are released, then go along to our website at www.ProgressingFinancialMarkets.com.

[28:40] And if you click on the "how to subscribe" link on the right hand side of the page, you'll see instructions there on how to be notified, either by email or how to subscribe to the RSS feed, or even how to automatically receive each new episode in iTunes.

[28:53] So, it just remains for me to thank our special guest today, Lee Hodgkinson. Thank you, Lee, for sharing your thoughts with us.

Lee: [28:58] Thank you.

Mike: [28:58] Thank you, Keith.

Keith: [29:01] Thank you.

Mike: [29:02] And thank you, Suzanne.

Suzanne: [29:03] Thanks.

Mike: [29:03] And from me, Mike O'Hara, thanks for listening, and until next time, goodbye.

Announcer: [29:07] Progressing Financial Markets was brought to you today by Voices in Business, helping our sponsors to achieve thought leadership in their business sectors. To find out more about what we offer, visit www.VoicesInBusiness.com. Thanks for listening. Goodbye. [music]

