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Looking Through the ICE at Electronic Trading

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Looking through the ICE at Electronic Trading

If there was ever any doubt about the importance of electronic trading in today's capital markets, surely the acquisition of the New York Stock Exchange by ICE (the Intercontinental Exchange, Inc. based in Atlanta, and one of the first electronic derivatives exchanges) would put the notion to rest. Looking at the corporate evolution of ICE is a bit like looking at the evolution of electronic trading itself, and it is an excellent primer on the evolution and future of electronic trading. A bit of history should suffice to make the point. However, if you have a solid grasp of the history of the NYSE and the ICE merger, you may want to just skip to "What Lies Ahead?"

NYSE Group

"On May 17, 1792, twenty-four stockbrokers gathered outside 68 Wall Street under a buttonwood tree to sign an agreement that would establish the rules for buying and selling bonds and shares of companies. The Buttonwood Agreement, as it is known, is so named because the tree served as the regular meeting place for these pioneers of Wall Street. The signers of the Buttonwood Agreement drafted their first constitution on March 8th, 1817, and named their nascent organization the New York Stock & Exchange Board."[1]

In 1863, the name was shortened to the New York Stock Exchange (or NYSE as it is commonly known), and carried on as such until April 2006 when the NYSE both went public (ending its membership-only status), but more importantly, acquiring the electronic stock exchange Archipelago, which became NYSE Arca. The combined company, the NYSE Group, combined with Euronext N.V. and Liffe in April 2007, to create an integrated international group of stock, futures and derivatives exchanges. Wow, this all took place only 6 years ago! They later acquired the Amex in 2008, which had been in business for over two centuries.

ICE

Intercontinental Exchange (ICE) was established in May 2000, with its founding shareholders representing some of the world's largest energy companies and global financial institutions. Current shareholders include Vanguard, Wellington, AllianceBernstein, State Street, Goldman Sachs and Morgan Stanley.

The original mission of ICE was to transform the OTC energy markets by providing an around-the-clock electronic marketplace for the energy markets that were otherwise largely fragmented and lacking in transparency. Greater efficiency, lower costs, more liquidity and improved price transparency were a welcomed change from more traditional methods of trade execution in the commodities markets, such as voice brokering, or open outcry.

ICE executed a strategy of expanding through the energy and other commodities markets, with acquisitions of European futures exchanges for core commodities such as Brent oil and gasoil (now

ICE Futures Europe), the New York Board of Trade, the world's largest canola market (Canada), environmental markets in Europe and the United States (Climate Exchange plc.), and BRIX, a Brazilian electricity exchange. Many if not all of these venues transitioned to electronic form. By the end of 2011, ICE Futures Europe's markets were fully electronic, and accounted for over 50% of the world's crude and refined oil futures contract volume.

In August 2008, ICE completed the acquisition of Creditex, an interdealer broker for the execution and processing of credit derivatives and began clearing services by launching ICE Clear Europe in November 2008 and ICE Clear Credit in March 2009. This was accomplished by the acquisition of The Clearing Corporation, or TCC, which operated a risk model for credit default swaps (CDS), which was then used by ICE Clear Credit and ICE Clear Europe for clearing CDS instruments.

By the time that ICE announced its plan to acquire NYSE Euronext, it had effectively integrated and rationalized much of the fragmented commodity markets trading and execution, and significantly penetrated the credit derivative markets. Importantly, they had also applied risk management systems that could be adapted and applied to different markets and different asset classes. Since its inception, ICE has been a leading proponent of electronic trading as a fundamental vehicle to integrate and rationalize disparate markets.

ICE Acquires NYSE Euronext

For some years now, the opening bell ceremony at the NYSE has seemed primarily a photo op for holidays and charities, rather than the introduction of newly listed companies or the celebration of significant market events. Only 13 years ago, ICE was an upstart newcomer --electronically trading commodities—and today it is about to acquire the New York Stock Exchange, the largest and most important equity trading platform in the world by market capitalization, and an organization encompassing extensive equity penetration as well as fixed income futures through Euronext LIFFE. Over the next year or two, I would expect to see many changes, across human resources, market structure, product offerings and cross asset integration. Although ICE has announced they will keep the NYSE iconic building, they have also announced a new headquarters uptown, and I cannot help but wonder how long it will be before the NYSE icon becomes another museum or condominium.

Electronic trading is behind these fundamental changes, in spite of some tremendous glitches such as the "flash crash" of May 6, 2010, and Knight Capital's erroneous trades in August 2012 which cost the firm over $450 million ... and its independence!

What Lies Ahead?

One question facing capital markets participants and regulators alike is what trends lay ahead. Following are my personal prognostications for the future.

First, consolidation will occur among the many exchanges globally and within large regional blocs such as Asia and Latin America. The March 2013 membership roster of the World Federation of Exchanges lists 57 names. Electronic trading will further penetrate local markets and then rapidly supplant traditional market structures. Inevitably global consolidation will continue, and the number of truly independent exchanges will decline further.

Second, all asset classes will fully embrace electronic trading. Fixed income instruments are one of the last asset classes to move towards full electronic trading. Having said that, companies such as MarketAxess and Tradeweb have offered electronic trading for over a decade. Banks such as Barclays offer their own platforms (Barclays is known as BARX). Other major players such as Goldman Sachs and BlackRock have announced or already implemented plans for electronic trading platforms in fixed income instruments. In Blackrock's case, clients can deal directly with one another thereby bypassing Wall Street altogether! A recent article in The Bond Buyer (featuring Michael Decker of SIFMA) also describes how the municipal bond market is definitely moving into electronic trading by beginning to utilize algorithms even at smaller and mid-size brokerages to respond to bid-wanted requests.

Third, arbitrage will accelerate across asset classes. For instance, commercially available algorithmic trading models now exist for arbitraging exchange traded funds against constituent cash instruments as well as futures. This requires high-frequency trading capability across both equity and futures markets, as well as algorithmic models designed to optimize such arbitrage. This type of arbitrage will no doubt continue to be extended globally to less liquid asset classes such as commodities and bonds.

Fourth, the range of electronic applications will continue to broaden horizontally with effective integration, providing straight-through processing from portfolio and risk management, to trade order execution with algorithmic trading and execution strategies, best execution, automated clearing and settlement, compliance and reporting. Electronic trading, dark pools, algorithmic trading and integration of asset classes across multiple platforms seem assured to grow.

Lastly, operational risk management will become even more important with greater global interdependence across trading venues and asset classes, ultra-low latency, and growing risks.

In retrospect, the truly remarkable thing is the speed with which electronic trading has accelerated throughout the capital markets, and fundamentally altered the landscape established over centuries.

What is our business?

"Success always obsoletes the very behavior that achieved it. It always creates new realities. It always creates, above all, its own and different problems. It is not easy for the management of a successful company to ask, 'What is our business?' Everybody in the company thinks that the answer is so obvious as not to deserve discussion. It is never popular to argue with success, never popular to rock the boat. But the management that does not ask 'What is our business?' when the company is successful is, in effect, smug, lazy and arrogant. It will not be long before success will turn into failure." - Peter F. Drucker[2]

References

Chronology of events at the NYSE Group and ICE are largely obtained from the NYSE Euronext website, and the ICE 2011 Annual Report, respectively.

1. http://www.nyx.com/en/who-we-are/history/new-york

2. ICE 2011 Annual Report

3. http://www.world-exchanges.org/member-exchanges/key-information-/2011-wfe-members N.B. Although the foregoing hyperlink references 2011, the actual web page shows March 2013 membership-accessed March 27, 2013

4. Muni Bidding Process Grows More Automated, by James Ramage, The Bond Buyer, March 26, 2013

About the author

Charly Gates is an innovative Hedge Fund, Credit, Derivatives, and Capital Markets consulting and instructional professional with an extensive track record in developing businesses for banks and investment banks. His successful career includes the creation of a boot-camp program for FRM (one of the largest European global hedge fund of funds, where he was the SVP of Learning & Development); and being on the ground floor of various firms' swap, credit derivatives, credit risk management consulting and private placement businesses.

During his tenure at Deloitte & Touche, LLP, where he was Co-head of Credit Risk Management Services, Charly developed credit risk management consulting services with their global client base. His expertise and seasoned background has culminated in him being a very approachable instructor who easily explains sophisticated concepts for participants in his learning events.

Presently, Charly has an active practice as a financial markets consultant, and as an instructor for GFMI.

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