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Global Online Trading, ECNs & ATSs: Will Asian-Pacific Markets follow the US in the New Millennium?

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Following are excerpts of an executive summary of a report entitled "Global Online Trading, ECNs and ATSs: Will Asian Pacific Markets Follow the United States in the next Millenium," prepared by **Gilbert &Tobin**, a law firm specializing in e-commerce in Asia-Pacific. Gilbert & Tobin has a practice interest in the regulatory-economic implications of online trading in Asia-Pacific. The full report can be downloaded from Gilbert & Tobin's website: **www.gtlaw.com.au**

"In a decade or two we will have one global Exchange and it will be in the ether," is one of the bolder predictions of the future. Indeed, the Internet is the future of the financial markets with information as its driver. Never before has the investor had access to so much information and the ability to act instantly on it from anywhere in the world. This phenomenon is quickly shaping the future 24-hour electronic market, vaulted by the development of advanced telecommunications networks, such as **ATSs** (Alternative Trading Systems) and **ECNs** (Electronic Communication Networks). The surviving market participants will be those who adopt Internet technologies to extend trading hours, globalise trading, lower trading costs and provide instant price discovery and trade execution. One fundamental question, however, is: **which market participants are more equipped to do this?**

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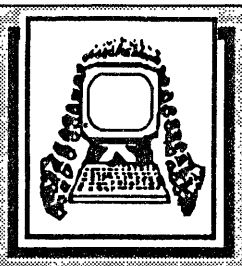
A recent suggestion is that the world's 230 stock markets would shrink to just five by 2010[1] and one of the main threats would be ECNs which currently compete with **NASDAQ** (25% of market volume) and, to a much lesser extent, the **NYSE** (3–5% of volume) by offering share trading in US listed stocks outside the home Exchange. (The lower percentage on the NYSE market being due to the restrictive off-market trading regulations and less accommodating market structure). The controversy these new systems have created is compounded when an **ECN** like **Island** claims to have processed over 10% of NASDAQ's volume with just two Compaq servers costing less than USD150,000 and a staff of under 20 people.

The authors argue that existing stock markets can and will provide the architecture to serve future global capital formation. The US experience of the growth of ECNs is not necessarily transportable to Asian-Pacific markets or any other markets which have fully automated trading and execution structures and offer greater market-depth transparency relative to their major US counterparts. However, when these US systems complete their current adoption of greater automated structures and commercialise through demutualisation, ECNs in their current form may well prove to be a passing fad. In any event, it is difficult to imagine ECNs overtaking US Exchanges, on which ECNs are dependent for the listing and price discovery of issued securities.

On the other hand, it is imminent that ECNs and ATSs (which are advanced trading mechanisms similar to ECNs but which do not compete with US exchanges) will expand into non-competing markets, such as efficient and transparent trading for otherwise low visibility over-the-counter products or emerging markets whose Exchanges do not traditionally accommodate, such as the small enterprises market. ATSs are also likely to expand internationally to provide single access entry point into multiple markets and to be used as electronic facilities by more traditional exchanges. One study estimates that such ATSs have grown at a geometric rate of 200% in the last 3 years[2] and are likely to form part of the future global market as emerging exchanges.

A comparison of the major types of stock market structures, their restructuring agenda and particular regulatory characteristics reveal the following significant trends and factors for the future global market:



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Asian-Pacific markets, which are typically *order-driven* auction systems are more evolved in automated execution than the **NASDAQ** *dealer* market and the **NYSE** *specialist* market. Notwithstanding that Asian-Pacific markets (excluding Japan) represent a small percentage of the world market, the efficiency of the fully automated platform provides little scope for ECNs to compete with these markets' liquidity monopoly. Such exchanges which have electronic-limit-order-book structures are the fittest for adopting advanced platforms such as open-interface and straight-through-processing (**STP**) (ie external access with no human intervention), which are the latest phases in market automation and expanding telecommunication broadbands. This will ensure the two critical elements of stockmarket survival in the cyber-age: **liquidity** and **investor choice**. Such automation is becoming imperative where the current financial system cannot sustain trading activity at the projected volume.

The Australian Stock Exchange (**ASX**) leads the Asia-Pacific with its introduction of open-interface (ie external access) to SEATS in November 1997 with the possibility of **STP** (ie no human intervention), which was introduced in Australia by E*Trade in November 1998. The significance of this is demonstrated by the narrowing of the gap between the ASX and US markets in online trading; approximately 16-18% of trades are currently done online in Australia compared to 25% in the US (nine months ago the statistics stood at 8% (ASX) and 15% (US)). Competing Asian-Pacific markets that are developing similar automated order-driven structures (eg **Tokyo, Singapore, Jakarta,** and **Hong Kong**) with open-interface and STP, will also be competitively placed.[3]

Currently, STP is generally not possible in the large US markets, where the trader must typically negotiate with a **NASDAQ market-maker** or the **NYSE's floor crowd** for price improvement before execution occurs. (This is with the exception of NASDAQ's Small Order Execution System with the use of Nasdaq's Application Programming Interface.) Market depth in these markets is also less transparent relative to automated markets. Consequently, ECNs have been able to infiltrate the US markets' liquidity because of such 'efficiencies holes'. ECNs essentially allow trading outside NASDAQ's and NYSE's market system by offering investors automated execution in an independent electronic limit order book which offers greater transparency.

Another important factor for the growth of ECNs is the regulation of off-market trades and ECNs' activities. Such regulations are less stringent in the US (in particular NASDAQ) compared to regulations in Asia-Pacific, which tend to be prohibitive of ECNs' off-market trades. Despite imminent deregulatory reform in Asia-Pacific, however, it is unlikely that ECNs can compete with exchanges on the fundamental principles of liquidity, counter-party integrity and regulatory infrastructure. This is compounded by the development of ATSs by exchanges to attract order flow; eg **SEHK's AMS/3**, which will accommodate online trading, and **NYSE's Institutional Xpress**, which will electronically centralise its 'upstairs' market. A potential niche for ECNs in automated markets, however, is to operate in the after hours or overnight phase, which is not fully automated by Asian-Pacific exchanges.

The US exchanges are following the ASX's evolving lead with further automation and commercialisation through demutualising in a counter effort to fend off the infiltration of ECNs. **NASDAQ** and **NYSE** are increasingly offering investors greater direct access and transparency. More recently, the SEC approved an enhanced NASDAQ execution system which will provide automatic execution of up to 9,900 shares. It is predicted that "this will have a real impact on ECNs in a negative way."[4] This will also create dynamic implications for competing exchanges when the US giants start selling their services to the world, including Australia.

As ECNs' competitive advantages diminish, the exchange in the ether is mostly likely to consist of an intermarket link between current major exchanges, who are able to satisfy the investor's need to access multiple markets through a single access-point; this investor today has sway over market liquidity and volatility, as exemplified by the current internet boom. The surviving exchanges will be those which demutualise, form global alliances through the provision of remote and reciprocal access to member-brokers, and provide open-interface to allow STP. These measures will serve to globalise markets in real-time and stem any leak of liquidity to competing ECNs and ATSs.

To survive as co-participants in the future market, ECNs and ATSs are likely to internationalise their platforms to take advantage of 'efficiency holes' in the globalisation process. Such holes may include the investor's need for simultaneous access to multiple markets not being met by its local market. Currently, **Bloomberg** and **Instinet** (two of the largest global ATSs) offer institutions global access to major exchanges, eg Instinet is a member of 18 exchanges and trades in 40 countries,[5] and in the near future, **NYFIX Millennium** will provide US institutions with a single network link with access to every equity exchange in the US with intelligent order-routing functionality. Expansion into non-traditional markets is also on the ATSs' agenda. For example, Instinet recently upgraded its platform to offer secondary trading in debt securities to its members, and recently the Association of Unit Trusts and Investment Funds (**Autif**) announced it will roll out in June 2000 a FIX-based platform for UK brokers that will enable them to trade shares of units trusts, and provide customers with consolidated holding account statements.