OICV | IOSCO
26-29 MAY 2008 PARIS
33rd ANNUAL CONFERENCE

PANEL 4

DERIVATIVES MARKETS AND CASH MARKETS: ISSUES AND CHALLENGES

PANEL 4

MARCHES DERIVES, MARCHES CASH : QUESTIONS ET ENJEUX

Jean-François Théodore
Deputy CEO, NYSE Euronext

A few years ago, we often talked about globalisation and consolidation, and about business opportunities that it may raise. But it felt like progress towards this goal moved at a very low speed.

Now global consolidation is happening in the exchanges industry – and fast. Why? Because this is no longer about building strong separate players on each continent, but to create big exchanges networks with entry point in different continents and offering various asset classes.

•••

Looking back to the past, exchanges traditionally start as national entities serving their local community, non for-profit organizations hold by their members. With luck they flourish, but eventually they exhaust the possibilities available within the national boundaries and seek to expand into other countries.

Historically, exchanges were also split between cash markets, where traditional securities, like stocks and indexes are traded, and derivatives markets, negotiating financial assets whose value depend on some other underlying instruments, like futures, options, swaps and warrants.

Due to their intrinsic leverage, derivatives, originally used to hedge commodities such as agricultural products and metals, embody more risk than standard products and were thus addressed to specific needs and clients. This was a reason, among others, to have disparate regulatory treatment for securities and derivatives.

But from mid 1980s some major structural developments had dramatically changed the whole financial markets' organization, boosting the need for consolidation among exchanges and the convergence between asset classes and market participants.

First, huge technological improvements and the introduction of electronic orders have given trading and post-trading activities new scale and potential, paving the way for greater competition between exchanges. In a fixed-cost industry like the exchanges' one, rationalization of IT infrastructures allows for an access to trading that is easier, more efficient, and cheaper.

IT also has no borders and allows to reach a much wider customer base and to bring more liquidity in the market. With the computerization of trading, exchanges thus have the opportunity to meet the increasingly international patterns of investing from market participants, who now have an international footprint and require efficient access to both cash and derivatives markets.

The most active customers of securities and futures have been converging too. The dealers who make business in these instruments all over the world are now the same or related entities as those who often hedge their risks from dealing in different products on a global entity basis rather than on a product-by-product basis.

As today's most active traders, many hedge funds, for example, have become dominant players in futures, equities and equity options, being the source of a constant stream of new synthetic instruments and fuelling the demand for integration between cash and derivatives instruments, as well as between fixed income and equity products.

The prominent algorithmic firms that opportunistically provide liquidity in equities are in many cases equally active liquidity providers in futures. And in a number of investment banks, derivatives and cash sales desks are being combined together as resources are being allocated to create and trade synthetic instruments.

In parallel, differences between traditional securities and derivatives have continuously eroded, as securities products have become more complex and include many leveraged structures, while futures industry volume is increasingly driven by financial and stock index futures products. In fact futures on single stocks and narrow-based indices are essentially forward instruments that share virtually the same pricing characteristics as equities.

Therefore in the recent years the derivatives business has become increasingly important in our industry, being for some underlying securities even more liquid, that is to say having trading volume larger than their underlying markets.

In this rapidly evolving context, the competitive trend is very clear: historically, exchanges typically traded stocks, options, or futures within a single nation's borders. Now issuers are aiming at bigger pools of liquidity beyond their domestic frontiers to finance their growth and reach international investors, while investors are more and more international, looking for opportunities on all asset classes.

Indeed, any successful provider of securities services must have a presence in the most important markets, both in terms of products and geography, while being at the forefront of information technology trends.

To stay competitive and serve customer demands, exchanges need to trade stocks, options, and futures on a single platform and to do so with a global footprint, creating a kind of "one-stop shopping" and offering superior business opportunities for issuers, investors and intermediaries. All recent moves in our industry fit squarely within the context of this competitive dynamic.

NYSE Euronext, the daughter of well established and recognized stock exchanges founded centuries ago, has always been a frontrunner in the field. France for example saw a large modernisation of its institutions and a radical change in stockmarket techniques, with the transition to electronic trading as early as in the 1980s.

The Paris bourse, on which trading was operated by the "agents de change" meeting in the exchange floor of the Palais Brongniart, saw its open outcry replaced by an automated trade execution system in 1986 while French financial derivatives exchanges MATIF and MONEP went fully automated in 1998. One year later, France's four market operators – SBF, MATIF, MONEP and Société du Nouveau Marché – merged to form a new and single bourse, listing both cash and derivatives instruments.

To go further, exchanges had to change their capitalistic structure. By going public starting in 2001, major European stock exchanges then operated their demutualization and were provided at the same time with new financial foundations from which to grow.

Almost all of the world's significant exchanges have now reorganized and are no longer membership organizations. Many of these exchanges have issued shares and gone public to finance their development of new and improved product offerings as well as their geographic expansion.

In particular this move not only promoted customer focus and created shareholder value but it also gave exchanges the means for their future development, through capital raisings or equity lines. Being listed enabled them to engage in external growth and make strategic moves into diversification, while also providing with a fair market valuation, facilitating mergers and acquisitions in the industry.

Indeed in 2000, three stock and derivatives exchanges, from three different European countries (France, Netherlands and Belgium at the beginning) merged to build what became the largest stock exchange in Europe, Euronext, with its extension a few months later to Portugal and to the London international derivatives business, LIFFE.

In 2007, for the first time in our sector, consolidation has bypassed the traditional borders. It went across the Atlantic to build a bridge between the first stock exchange in the world – NYSE, the first exchange in US dollars of course – and the first pan-European exchange – Euronext – the first exchange in euro, with the creation of NYSE Euronext.

As the world's leading and most liquid exchange group, NYSE Euronext today has a family of exchanges located in six different countries, including the New York Stock Exchange, the world's largest cash equities market; Euronext, the Eurozone's largest cash equities market; LIFFE, Europe's leading derivatives exchange by value of trading; and NYSE Arca Options, one of the fastest growing U.S. options trading platforms.

NYSE Euronext offers a diverse array of financial products and services for issuers, investors and financial institutions in cash equities, options and derivatives, ETFs, bonds, market data, and commercial technology solutions, thus benefiting from highly diversified sources of revenues. If listing and equity trading accounts for 13% and 27% of NYSE Euronext's revenues respectively, 24% of the business comes as well from derivatives trading.

Indeed NYSE Arca offers a wide range of US equity options while our international derivatives business Liffe offers an international product range – from futures and options in interest rates, equities and indices to swap products, bonds and commodities. Many of products that we offer, like the Euribor in Europe, are global benchmarks.

These diversified revenue streams for which profitability is growing, put NYSE Euronext in a strong situation to expand in many directions and position the Exchange as a real multi-country, multi-assets exchange.

NYSE Euronext is first a world leader in listing activities. Over 4,000 companies from 55 countries are listed on its 6 stock markets in New York, Chicago, Paris, Amsterdam, Brussels and Lisbon, representing a combined USD 30 trillion market capitalization, more than four times that of any other exchange group. 80 of the 100 of the world's leading global corporations are listed on NYSE Euronext's markets. And last year NYSE Euronext raised more capital than any other exchange in the world, through a total of 420 listings.

With its unrivalled brand name NYSE Euronext has a very attractive listing offer, providing issuers with a wide choice in terms of currency of listing – euros or dollars –, of accounting standards, – IFRS or US Gaap – and of listing requirements – from US SEC SOX benchmarks to lighter exchange ones.

Whatever their size and location companies wishing to raise capital on NYSE Euronext can enter through one of the 4 listing venues: NYSE, NYSE Arca, Euronext or Alternext, our exchange-regulated market sized to small and mid cap firms looking for streamlined listing requirements and trading rules, created 3 years ago, with already more than 120 companies listed.

NYSE Euronext intends, not only for its domestic issuers but also for foreign ones, to be a partner of choice for companies looking for a dual listing in their domestic currency and in euros and/or in dollars. Regulation authorities have strengthened their relationships since the NYSE Euronext merger, and are still working in good cooperation.

Accordingly to strong positioning on listings, secondary trading on NYSE Euronext's markets is also impressive, even before last summer crisis, with a two-digit increase in number of trades each month since the beginning of the year compared to 2007, which was already a record year.

Today more than one trade out of the three completed on the world's stock exchanges is processed on NYSE Euronext markets and systems, which means an average of approximately USD 141 billion traded every day on our markets.

And NYSE Euronext markets, representing the largest pool of liquidity in Europe, have shown just how useful they can be for investors in times of high market volatility, such as we have recently seen. Our markets have given them the depth, liquidity and transparency they need. That is clearly reflected in the record trade volumes seen on our markets since last summer.

In fact beyond liquidity NYSE Euronext has the advantages of technological excellence and quality of execution. And at a time when information technology is more critical than ever in the current competitive environment, we are keen to make sure we continue to be able to meet the evolving needs of its customers.

PANEL 4 | DERIVATIVES MARKETS AND CASH MARKETS: ISSUES AND CHALLENGES

Trading strategies and activities have evolved at a very fast pace in recent years. The great variety of instruments and products (blue chips, structured products, derivatives, trackers) available and the diversity of market contributors and their associated trading activities, ranging from the traditional to the most pioneering (such as algorithmic trading and black box trading), underscore customers' need for speed, flexibility, capacity and reliability.

That's why Euronext markets have switched last year to a Linux-IBM technology, enabling their systems to process an order in under two milliseconds and largely increasing trading capacities. We'll go even further soon with the planned harmonization of all NYSE Euronext trading platforms under the Universal Trading Platform umbrella.

By end 2009 NYSE Euronext will have unified trading systems. This will result in a universal platform for all products listed on NYSE Euronext markets, on both sides of the Atlantic, and as early as end 2008 for European shares, thus offering users savings and new scope for business development.

Within the Euronext universe, between 2002 and 2005 the share of trading on each Euronext marketplace originating from members not located in the corresponding country (cross-border trading) increased from 9% to 23%. And trading costs were also continuously decreasing with better liquidity and harmonized and more efficient IT systems.

Indeed NYSE Euronext is well-equipped to face with the new environment that emerged last November with the Markets in Financial Instruments European Directive (Mifid), enabling the launch of alternative trading platforms to traditional stock exchanges. Mifid is a source of innovation in our industry, and as such offers NYSE Euronext a lot of opportunities, based on the liquidity, transparency and state-of-the-art trading technology of its markets.

In addition, NYSE Euronext has broadened its range of services to gain an added edge, with for example the implementation of a new trade-execution algorithm for equity markets that cuts the total cost of a trade by up to 40% and the successful launch of an offer for real-time publication of trades off the order book for all European equities and of a service for the declaration of trades to Euronext regulators. NYSE Euronext also reacted to proposals from its members and extended price quotes to four decimals (decimalization), which allows added precision in orders.

Finally, NYSE Euronext has teamed up with BNP Paribas and HSBC to set up Europe's first multilateral trading facility, SmartPool, to facilitate block trades in European stocks. This has been followed by a similar move in the US with the BIDS block-trading facility.

NYSE Euronext definitely has innovative services that will help its customers achieve best execution and report their trades under the MIFID and Reg NMS rules, respectively in Europe and in the US.

So what's next? Well, consolidation is clearly still under way in our sector, in this new age of multi-country, multi-asset exchanges. All recent moves we have seen confirm that to stay competitive in a fully globalized economy an exchange has to become more global and to create economies of scale.

The consolidation has so far mainly concerned exchanges in Western Europe, in the US, and more significantly the NYSE Euronext merger between US and Europe exchanges. It is unlikely that Asia will stay aside of this consolidation move, being the place the stronger growth in GDP and in trading. And NYSE Euronext will stay at the forefront of the consolidation move.

Steps in this direction have already included NYSE Euronext's strategic alliance with the Tokyo Stock Exchange to explore new opportunities in trading systems and technology, investor and issuer services, investment products, and governance and regulation. Our global strategy also lead to the acquisition of a 5% equity position in both the National Stock Exchange of India and the Multi Commodity Exchange, India's largest multi-asset exchanges.

More globally, in a competitive environment marked by constant change, NYSE Euronext is pursuing a strategy for development based on a highly diversified offering of innovative products and services with worldwide appeal.

The acquisition of Amex, which was finally agreed on at the beginning of this year, is in perfect keeping with this strategy based on a full offering of products and services for global markets while also confirming NYSE Euronext position as a driver for industry consolidation.
A cooperation agreement with the Luxemburg Stock Exchange has also been set up to develop a common standard for the listing and trading of corporate bonds through the use and promotion of a comprehensive, integrated solution incorporating state-of-the-art technology and aligned with the best market practice.

More recently, NYSE Euronext's strategy was also illustrated by a partnership with Caisse des Dépôts for BlueNext, which is part of a broader ambition to become a world leader for trading in environment-related products, including carbon emissions.

•••

In the long term, there should remain only two, three or four global networks of exchanges around the world, with the most competitive exchanges in the future being multi-country and multi-asset businesses.

NYSE Euronext, which has been the first mover and is now the largest player in the industry, will continue leading consolidation. NYSE Euronext can count not only on its organic growth but also on its perfect global positioning to take advantage of any opportunities. Provided, of course, that they make strategic and financial sense.