The Challenges for Stock Exchanges

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Stock Exchange, the old and venerable institution that is at the center of financial markets all over the world, is set to undergo major transformation in the years ahead. While the basic role of the stock exchange – an enabler of trading in securities will remain unchanged, the manner in which it is done, will get redefined as the globalisation process unfolds.

The first major challenge that the stock exchanges face is to ensure transparency and efficiency in their business. In the globalised environment where funds flow across the world at the touch of a button, highest standards of corporate governance are bound to become the norm in the years ahead. It is no co incident that the period of capital market reforms in India has co-incided with that of large inflows into the capital markets. While technology makes it easier for exchanges to provide efficient trading, clearing and settlement services, the risk of loss of trust in the markets on account of failure of listed companies to adhere to the letter and spirit of the stringent corporate governance norms, remains.

Ensuring corporate governance standards will be a major responsibility of the exchanges in the future. Already, compliance has emerged as one of the top priorities for top management. There is every reason to believe that this trend will gain further strength in the future. For the stock exchanges, the challenge would be to take corporate governance beyond legislation and moral posturing and operationalise it in a letter and spirit.

The stock exchange of the future would not be constrained by national boundaries so far as listing of companies is concerned. Most stock exchanges would have companies from a number of countries and conversely most large companies would typically be listed on more than one exchange. This has two major implications for stock exchanges. On the one hand, they will be faced with the challenge of fragmentation of liquidity. On the other, there would be issues of regulatory overlap. Fragmentation of liquidity can be a serious threat but it will compel exchanges to become extremely competitive, which would be a positive development.

This process will be facilitated by consolidation among exchanges, which is expected to bring down the costs of cross border trading significantly. Cross border trading on a large scale would present challenges of bringing about effective integration of depositories. This is easier said than done. Integration of depositories is difficult because each depository is rooted in the legal and institutional framework of the country in which it is based. In Germany, Italy and Spain the local stock exchange owns the depository, in most other countries this is not the case. However, it may be pointed out that we do have some examples of mergers of cross border depositories. Swedish and Finnish depositories are now part of the same legal entity, NCSD. Similarly, the Euroclear group has brought together the depositories of five European countries – Belgium, France, Netherlands, UK and Ireland.

There would be pressure for harmonsation of standards in the years to come. The logic of cross border listing requires a certain uniformity in accounting standards, disclosure and other corporate governance norms and in market practices, apart, of course, in the vital area of clearing and settlement. Stock exchanges across the globe would be required to converge toward a commonly accepted standards possibly worked out by organizations like IOSCO.

The exchange of the future would have to devise ways and means to handle products of a very different kind. To give only one example, there would be a growing segment of environment related financial products. Finding the mechanisms to accommodate such products on the exchanges would be a challenge. A beginning in this direction has already been made with the Chicago Climate Exchange clocking growing volumes. In the days ahead, trading in derivatives based on environmental products will become mainstream. One could also see sports related derivative products which would also require stock exchanges to adapt themselves to facilitate trading therein.

A whole new range of challenges would relate to protection of critical infrastructure. The need to ensure business continuity and consequence management will become increasingly important. With the emergence of ever more powerful softwares, stock exchanges will have to face the challenge of disruption in trading caused by non market factors (terrorist attacks, for instance) and learn to protect themselves against information systems attacks and e crime.

The increasing role of private equity and hedge funds has the potential to pose a threat to the stock exchanges. This is because the hedge funds have large funds at their command ($ 436 billion as per one estimate) and they take very large positions which can be reversed very swiftly. Their activities are bound to test the robustness of stock exchange systems and process in the areas of surveillance, clearing and settlement. Private equity is slightly different in nature, usually having a longer time horizon for its investments. However, given the very large funds at their disposal ($ 1.23 trillion) they are capable of very large transactions which could result in a sharp rise in volatility on the exchange.

As stock exchanges get integrated in the global financial matrix, we are likely to see an increase in volatility. This is because risk associated with any single market will have global ramifications. As the role of external investors increases (as we have seen in our country) their reactions will entail massive movement of funds into and out of the markets. Our experience has been that FII inflows and outflows have a very direct bearing on the volatility and this is likely to continue into the future, particularly in a scenario where there are no exchange control restrictions on movement of capital.

Volatility is also likely to increase in the future on account of the growing importance that algorithmic trading will enjoy in the days ahead. The problem that algo trading poses is that it can very strongly reinforce an upward or a downward trend in the stock market, thereby generating higher stress on risk control systems at an exchange. Fully automated trading with no human intervention accounts for 30% of trades in Europe and the US. In the years ahead, the spectrum of orders that can be completely managed by computers will increase as algorithms become more sophisticated.

Given the growing importance of algo trading, stock exchanges will have to provide real time feed (tick by tick), ensure low latency and develop risk management systems capable of real time position keeping as black boxes are active on different exchanges, both in cash as well as derivative segments.

A major threat to the exchanges in the years ahead is from electronic commmunicaiton networks (ECNs) which are emerging as alternatives to stock exchanges. These are essentially trading platforms which enable large investors to come together with their bids and offers and create a parallel, more efficient and anonymous market. At the moment, in most countries, regulation provides protection to exchanges against such alternative price discovery mechanism. However, it is by no means certain the this protection will be available ad infinitum. The emergence of LiquidNet and Dark Pool is a harbinger of things to come.

In fact product diversity will be considerably more than what we have today. There could be a number of asset classes and not merely equities, traded on the exchange. The challenges for the risk management function in such a scenario are obvious. Stock exchanges will have to devise systems and procedures to take care of positions across asset classes or across geographies. The systems should be sufficiently flexible to accommodate quickly the requirements of new and more complex products which would be continuously evolving. In fact aggregation of market positions across asset classes and across markets would be a major challenge for the stock exchanges in the years ahead.

We must also keep in mind the impact of exchange rate fluctuations on volatility. As more and more countries give up currency control, we would have one seamless financial market universe which would require altogether different level of sophistication in terms of regulation, technology and risk management practices.

Going forward, there will be a marked increase in shareholder activism. Stock exchanges will therefore have to tweak their systems and procedures to make themselves more open and more accessible to shareholders seeking specific information.

Clearly, managing a stock exchange in the days ahead will be a whole new ballgame.