Student Handout for TMX Merger Class Discussion

Canadian Business History – MGT 2917

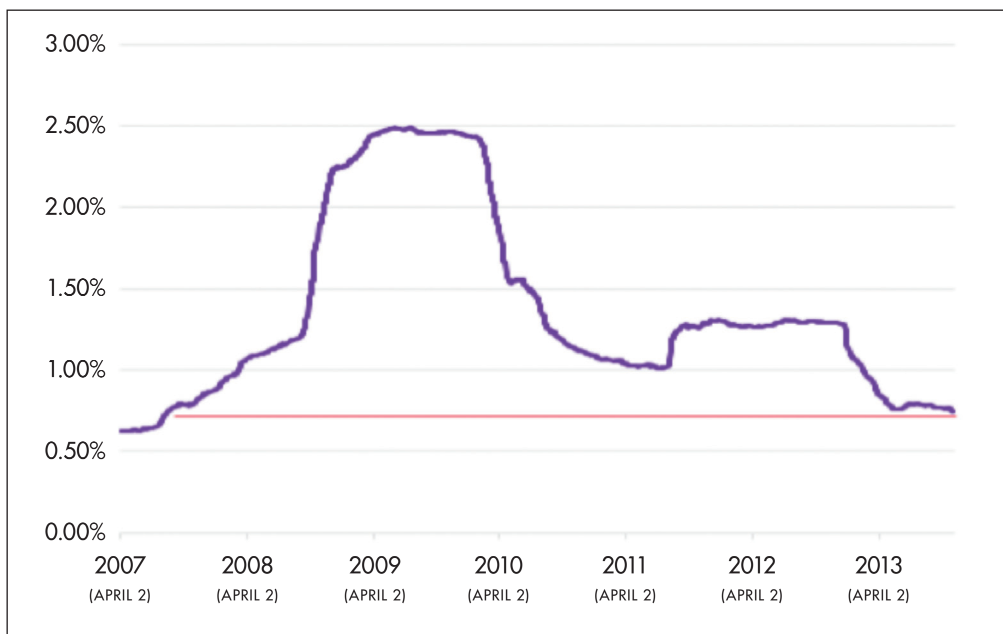
Toronto and Montreal Stock Exchange Merger Case

By early 2008, many stock exchanges around the world had consolidated into national platforms. Of these, many included cash and derivatives trading as well as clearing. The United States was a notable exception, in that it still had multiple exchanges. This, combined with the fact that it was home to one of the most developed alternative trading systems (ATS) industries, made the U.S. the world's most competitive exchange market. This competitive intensity had already driven the NYSE to strive for the first truly global merger by acquiring Euronext a year earlier. Although other mergers were also rumoured, the emerging financial crisis quickly took centre stage and M&A activity ground to a halt.

The credit crisis dramatically increased market volatility during 2008-09 (see Exhibit 1). This created trading opportunities for high frequency trading (HFT) firms and during this period exchanges performed well from the resulting high transaction volumes. ATSs attracted more of this volume than traditional exchanges because of pricing models that offered substantial rebates to market participants who provide liquidity.[1]

Exhibit 1

S&P500 Daily Volatility – 2007 to 2013 (1-year rolling window)



Source: SoberLook.com

[1] Firms are said to "provide liquidity" when they post buy or sell orders that "make" a trade happen. Firms that accept those buy/sell orders are said to be "takers" of liquidity. Liquidity takers are charged a fee, a portion of which is rebated to providers of liquidity.

By early 2010, however, volatility declined and a “new normal” of lower asset values and interest rates set in. As returns became harder to come by, investors became more focused on execution quality.[2] The resulting narrowing of bid/ask spreads limited HFT opportunities, which reduced the transaction volumes that were the primary revenue stream for exchanges and ATSs. It also put additional pressure on trading fees.

As the competitive nature of the exchange industry intensified, M&A activity re-emerged after a three-year pause. Singapore took the lead in October 2010, bidding for Australia in an attempt to better compete with the regional behemoth, Hong Kong. Then, on February 14, 2011, plans for two separate historic mergers were announced: The LSE and TMX announced their agreement to merge, creating a global natural resource powerhouse; later that same day, Deutsche Boerse announced its intention to acquire NYSE Euronext to form the largest exchange in the world.

This wave of deals was different from those that dominated the landscape from 2004 to 2007. Where the transactions done before 2008 had mostly been about reaping economies of scale, the 2010-11 announcements were about acquiring new capabilities from which to create cross-selling opportunities. The financial crisis was a key catalyst for this shift; it was driving an unprecedented wave of regulatory activity aimed at increasing transparency and reducing risk in global derivatives markets. While this would increase the complexity and cost of doing business, it ultimately created two important growth opportunities for exchanges: listing derivatives that had previously only traded OTC; and centralizing clearing for the remaining OTC activity. Both of these opportunities relied on clearing capabilities that could span the interest rate, commodity, futures and credit segments of the derivatives market. The substantial capital and infrastructure investments associated with building these capabilities became a strong impetus for continued M&A activity.

The other distinguishing feature of the transactions announced in 2010-11 was that none were consummated. While the Australia/Singapore merger was blocked by the Australian Treasurer on nationalist grounds, the failure of the Deutsche/NYSE and TMX/LSE marriages were reminders of the strategic importance of exchanges to regional financial markets. Local market participants proved they were not going to let transnational mergers go through without careful consideration of the broader consequences.

The rejection of the Deutsche Boerse/NYSE Euronext merger was a particular reflection of the strategic importance of derivatives and regulators’ acknowledgement that preserving competition among exchanges was key to the effective functioning of their capital markets. The decision came down to two key points:

1. The exchanges argued that because they specialized in different types of interest rate futures, their Liffe and Eurex derivatives exchanges did not compete with each other. However, unlike Canadian regulators who approved the TSX/MX merger, European regulators argued that the prospect of competition between the two was a significant factor in keeping costs down, and as a result, their combination would lead to an unacceptable increase in market power.

2. The exchanges further argued that while their combined operations would represent a dominant share of European listed derivatives, this was dwarfed by global and OTC markets, which

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[2] Execution quality is broadly defined as a small bid/ask spread.

represented viable alternatives for market participants. While this logic may have held for cash markets, regulators rejected that argument for derivative markets. With respect to global competition they asserted that because listed derivatives are proprietary products, exchanges in other parts of the world would be unlikely to be able to offer comparable risk management vehicles. Regarding competition from OTC products, regulators declared that the larger contract size (8 times on average) and non-standardized nature ruled them out as substitutes.

The LSE/TMX deal failed for very different reasons. When the merger was announced, the Canadian financial community mobilized by forming a consortium[3] to buy the exchange and merge it with Alpha (the ATS founded by the big banks in 2007) and the national securities clearinghouse, CDS. The synergies from such a combination were substantial: infrastructure consolidation with Alpha; new product opportunities from integrated clearing; and streamlined executive management across all three entities. This upside made it possible for the consortium to top LSE's offer price and shareholders supported the option that created the most value for them. After a year of consultation and negotiation, Canadian regulators ultimately traded domestic competition for a Recognition Order restricting TMX's ability to raise prices and the promise of creating a stronger Canadian institution that would be better equipped to innovate and compete on the world stage.

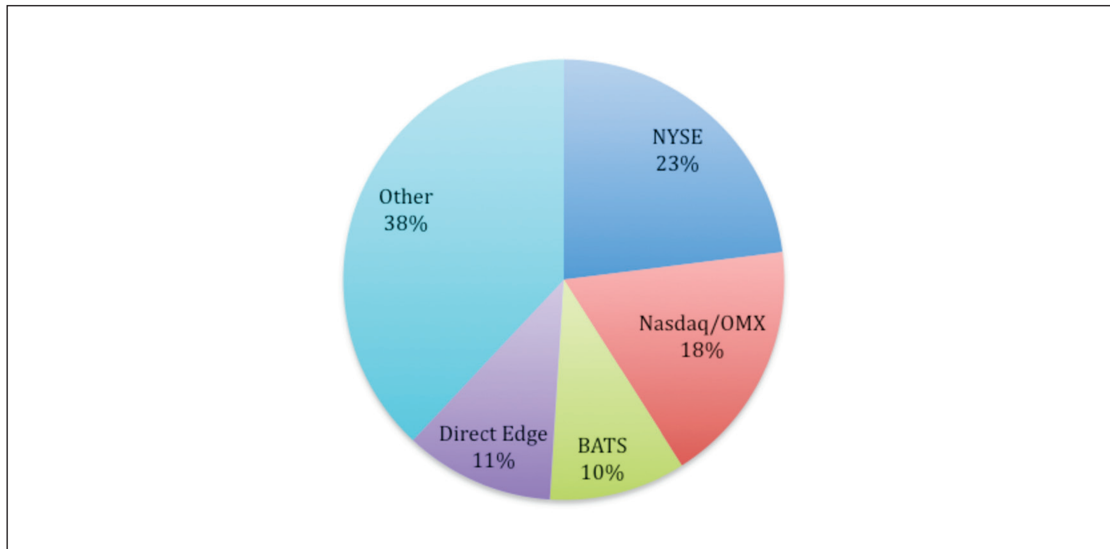
The decision was extremely controversial, with many market participants objecting on the grounds that competition would be expected to reduce prices, not just prevent them from going up. Many believed that Alpha offered a credible alternative that succeeded in keeping TMX pricing in check. Moreover, with such a large percentage of the country's market participants involved directly in the deal, the potential for the remaining players to mount a credible competitive threat would be limited. Three years after NYSE's acquisition of Euronext, the promise of global cash equity exchanges had yet to be realized. There were two primary obstacles: first, the lack of harmonization of listing and compliance requirements across jurisdictions; second, local market participants continued to exhibit a strong preference for doing business in their local market, where they knew the people and business culture and were not affected by time zone differences.

Amidst the failure of global exchange mergers, ATSs continued to take market share from traditional exchanges. The 2011 merger of ATS leaders BATS and Chi-X augured for even stiffer competition. While at its peak NYSE had dominated trading in its listed companies with market share of more than 80%, but by late 2012 it was the locus of only 23% of that volume. (See Exhibit 2 on page 4.) The story came to its logical conclusion on December 20, 2012, when the 12-year old Intercontinental Exchange (ICE) announced a bid for NYSE. NYSE's Liffe subsidiary, the London-based commodity-focused derivatives exchange, would enhance Atlanta-based ICE's ability to compete more effectively against derivatives behemoth CME Group, which controlled 90% of the U.S. futures market. Perhaps the most telling aspect of the deal was ICE's plan for Euronext — the cash equities exchange was deemed to be irrelevant to the achievement of ICE's objectives, and the intention was to dispose of it.

[3] The four bank-owned investment dealers in the group including CIBC World Markets, National Bank Financial, Scotia Capital, and TD Securities will hold a total of 22% while the country's largest pension funds (Alberta Investment Management, Caisse de depot et placement du Quebec, Canada Pension Plan Investment Board, Fonds de solidarité des travailleurs du Quebec and the Ontario Teachers' Pension Plan) would own 31%. Independent dealer representatives (Desjardins Financial, Dundee Capital Markets, GMP Capital and Manulife Financial) would together hold the remaining 7%.

Exhibit 2

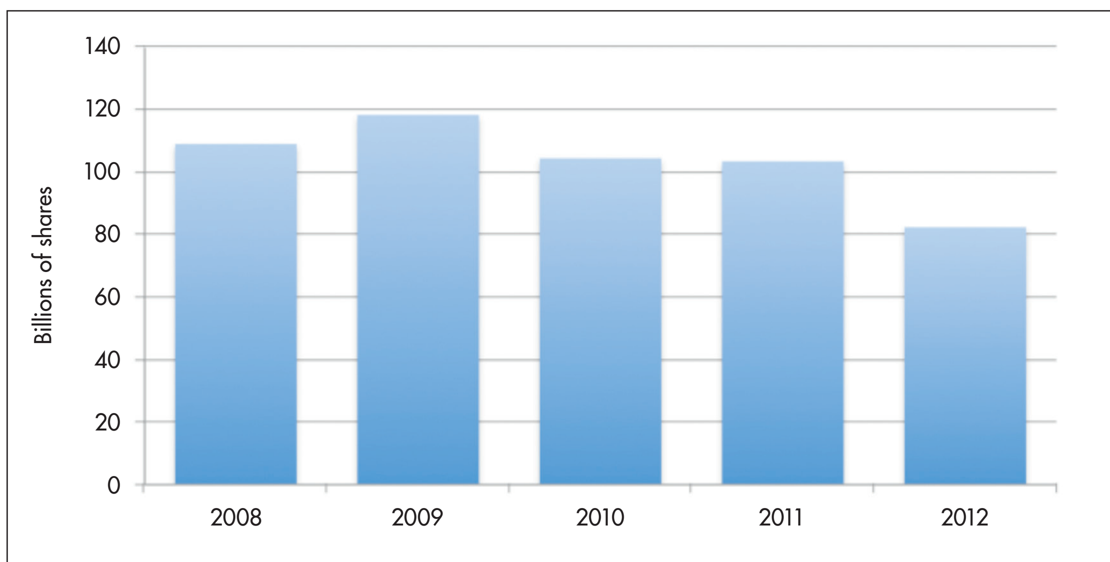
U.S. Equity Exchange Market Share – 2013



The ATS sector proved it was not immune to continued declines in transaction volumes. In 2013, shares changing hands on all U.S. exchanges had declined 36% from their 2009 highs.[4] The decline in Canada has been even sharper. (See Exhibit 3.)

Exhibit 3

Securities Volume Traded on the Toronto Stock Exchange – 2008 to 2012



4 According to data compiled by Bloomberg and Rosenblatt Securities Inc.

Industry challenges were exacerbated by a string of technical issues, particularly with BATS. The highest profile of these was the mini flash-crash of BATS' own shares on the day of its Initial Public Offering (IPO) on March 24, 2012. BATS' own stock was the first IPO to be conducted on the ATS and this fiasco ultimately resulted in the company's cancellation of its efforts to go public.

Against this backdrop, the merger announcement in December 2012 of HFT industry leaders Knight Trading and Getco, (the two biggest ATS clients in the U.S.) all but assured the combination of BATS and Direct Edge.[5] This merger was announced in August 2013, less than three weeks after BATS went dark as the result of yet another computer system failure. The deal will create the second-largest U.S. stock exchange, leap-frogging over Nasdaq and landing right behind NYSE Euronext in terms of equity trading volumes. Creating a credible alternative to NYSE and Nasdaq's listing and data services is certain to reshape the global competitive landscape for exchanges in 2014 and beyond.

5 Knight Trading and Getco were major shareholders of both BATS and Direct Edge. Other shareholders of BATS included Morgan Stanley, Citigroup, Credit Suisse and Nomura Securities, while Direct Edge was owned by Goldman Sachs, Citadel and JP Morgan Chase.