A case of terminal consolidation

Derivatives exchanges that are shifting to electronic platforms are seeing their trading volumes skyrocket. But this new-found bounty of revenues is not trickling down to the exchange connectivity providers, among whom a shake-out is imminent. By Victor Anderson

The London International Financial Futures and Options Exchange (Liffe) enjoyed a bumper 2001 – trading volumes soared 65% to 216 million contracts. Other exchanges have registered similar volume jumps upon changing from the traditional open-outcry trading format to an electronic platform.

Helping to make electronic trading possible are the exchange connectivity tools. Created by independent software vendors (ISVs), these software packages provide trading front-ends, enabling connectivity and interoperability with the application program interfaces (APIs) of the individual exchanges. This allows member organisations and their clients to execute online trades, which are automatically risk assessed, routed, matched and settled.

But the ISVs are unlikely to benefit from the surge in trading volumes to the same extent as the exchanges themselves, in part because the market-place for exchange connectivity tools is very fragmented – there are more than 20 companies offering these products at the moment.

Market leaders include Bloomberg and GL Trade – the industry's largest players in terms of trade volumes and the number of exchanges they offer connectivity to – as well as NYFIX, Trading Technologies, RTS Realtime Systems, ORC Software and Patsystems.

Indeed, a shake-out is in the works, say industry experts. "I believe that there is only space for about five or six ISVs in the connectivity market," says Nick Garrow, global head of sales at London-based Patsystems. "I think the big trend this year will be consolidation."

Alison Wood, European sales and products manager for electronic trading at JP Morgan Chase, is even less optimistic. She expects "five or fewer" to survive the coming 18 months.

A change in environment

Banks – many of which established alliances with more than one ISV – have appraised the connectivity tools on offer and are now primed to jettison the applications that don't make the grade. Another part of the problem is the wave of global mergers that have hit the derivatives exchange industry – more mergers means fewer exchanges for ISVs to sell their connectivity tools to. For example, as a result of its merger with the Franco-Benelux cash and derivatives exchange Euronext, Liffe is currently assessing the 17 ISVs offering connectivity to its API with the view to establishing a three-tier hierarchy based on their respective functionalities.

This rating system is being developed ostensibly for the benefit of Liffe members, who in future will be able to select an ISV based on functionality. It is likely however, that first-tier ISVs will see an increase in demand for their services at the expense of those vendors making up the second and third tiers.

But just as the potential pool of client revenue is shrinking, demand for functionality by clients is on the rise. Gone are the days when connectivity to a handful of the major exchanges, colourful screens and a motivated sales force were sufficient to guarantee your survival until the next round of funding. The future demand for ISV services is unlikely to depend solely on basic connectivity, but more on 'value-added services', which are fast becoming the new industry buzzwords. Morgan's Wood explains: "In our experience, clients' demands have shifted from focusing on systems that deliver 'pure execution' to systems providing the functionality to formulate and execute 'trade ideas'. We feel that the ISV needs to be heading in that direction – not just bridging the gap between the client and the market, but also bridging the gap between the origination of an idea and the trade. If an ISV cannot make this transition, they will struggle to compete."

In an industry that is so technologically driven, keeping ahead of the competition, or at least abreast with it, is a never-ending struggle. The cost of developing new software, upgrading existing applications and running the necessary support team to look after the clients' interests is a huge drain of financial resources. "It's quite simple to develop these gateways so that traders can access markets and execute their orders," says Malcolm Donaldson, managing director for London and northern Europe of French-based ISV, GL Trade. "What is difficult is to maintain that position because you constantly have to upgrade your software and support a large development team."

"Technology in this space is not cheap," says Woods. "ISVs without the ability to keep up with the pace of development will suffer as their financial success is reflected by whether or not they are meeting the brokerage community's demands in terms of the functions they offer and the exchanges they have connectivity to."

Indeed, in the wake of the dot.com bust, clients are beginning to scrutinise ISV bottom lines more closely in order to mitigate the potential risk of being left stranded by a company heading for Chapter 11 territory. "Part of our 'white label' agreement with JP Morgan Chase to re-distribute our products and services to their clients was decided by the fact that we're likely to be around in a few years time supplying that technology," explains Donaldson. But as a number of service providers will testify, enjoying sufficient financial clout to ensure one's long-term presence in the industry is only half the challenge.

Alison Wood, JP Morgan Chase: Clients want to execute 'trade ideas'

"ISVs will need financial security to carry them forward to profitability, says Chris Stone, managing director of London-based ISV, FFastFill. "To get there they will need the product range to diversify their revenue streams and not just the initial idea that the business model was based on – multiple screen selling." □