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Canada's TMX Group Will Have Assets Covered

December 17, 2007 *By John Hintze*

Canada fell into line with global exchange consolidation last week as TSX Group of Toronto and the Montreal Exchange (MX) announced an agreement to merge into a multi-asset-class market operator, though back-office impediments may stall an important benefit in the clearing area.

The new company, TMX Group, will combine TSX's Toronto Stock Exchange--Canada's largest--with the derivatives market in Montreal. The headquarters will be in Toronto, and derivative operations will remain in Montreal. TSX also owns a public venture equity market, TSX Venture Exchange, as well as the Calgary-based Natural Gas Exchange (NGX) and interdealer broker Shorcan.

"The new group will redefine the Canadian capital markets and strengthen [their] global positioning," said TSX chief executive Richard Nesbitt, who anticipates $25 million in cost savings from the merger. "TMX Group will list, trade, clear and offer market data for both cash and derivatives markets across multiple asset classes."

Nesbitt will continue as CEO of the merged firm; Montreal Exchange president and chief executive Luc Bertrand will be deputy CEO while retaining his positions at the derivatives exchange.

"The combined entity will have the resources and scale to develop new capital markets products and new high-value data services, and combine them into a much larger database," Bertrand said in a press conference on Dec. 10.

The two exchanges are approaching the end of a ten-year non-compete agreement that confined the Toronto exchange to trading equities and focused MX on derivatives. TSX in March signed an agreement with New York's International Securities Exchange (ISE) to create an ISE-like exchange called DEX to trade options, futures and options on futures for a range of Canadian securities. That initiative had been expected to go live when the non-compete agreement expires in March 2009.

Now that the merger has rendered the non-compete agreement moot, the future of the joint venture--TSX would have held a 52 percent stake, with the remainder belonging to ISE, which is in the process of being acquired by Deutsche Borse--is unclear. "We've spoken with our partners at TSX. No decision has been made yet about DEX," said an ISE spokesperson, adding, "We do have contractual protections in place for ISE and will evaluate the appropriate course of action."

MX has also made inroads in the U.S., buying a 31.4 percent stake in the Boston Options Exchange

(BOX) that it is seeking to increase to 53 percent, following an agreement in October by BOX's parent, the Boston Stock Exchange, to be acquired by Nasdaq Stock Market. In March, BOX implemented the Sola trading platform developed by MX--well known for its technology expertise. Bertrand emphasized that TMX "sees strong prospects for growth outside Canada, particularly with the BOX."

In February, MX agreed to provide trading and clearing of exchange-traded and over-the-counter crude oil, natural gas and electricity products from the New York Mercantile Exchange, and to sell a 10 percent stake to the commodities exchange.

TMX will find itself in an increasingly fragmented Canadian securities market. A half dozen alternative trading systems (ATSs) have opened, or will shortly, with at least three specializing in smaller-size displayed orders typically traded over exchanges. Pure Trading and Omega recently began operations, and New York-based agency broker Instinet will launch Chi-X Canada early next year.

Renee Colyer, founding principal of Toronto-based research firm Forefactor, said the new competitors were a likely factor in the decision to combine the exchanges. Perhaps more important, she said, was the global trend of exchanges getting larger through mergers, often across borders, and offering multi-asset-class trading. "If I could go to one exchange and trade options, equities and futures all on the same platform, it would be a much simpler process than directing the trades to different markets," Colyer said.

Bertrand noted that investors have rewarded exchanges pursuing that concept--the mergers of the New York Stock Exchange and Euronext and Deutsche Borse's acquisitions of Eurex and ISE, for example. "We see higher price-to-earnings multiples on integrated exchanges than cash-only ones," he said.

TMX, however, will be missing an important element. The Toronto exchange currently clears its transactions through CDS Clearing & Depository Services, which it co-owns with Canada's largest banks. Robert Young, managing director of Liquidnet Canada, another ATS focusing on institutional block trades, noted that hybrid exchanges such as NYSE Euronext and its Euronext.liffe derivatives exchange clear their own trades. Consequently, he added, they can provide investors with significant collateral reductions for risk-offsetting transactions.

The TSX-MX merger "doesn't position the end organization any better to address the competition from" ATSs, said Young, who was VP of sales and marketing at TSX until three years ago.

Liquidnet, of course, is one of those systems, although Young noted that the ATS focuses on block trades and is open only to institutional investors, rather than the retail and fast-paced algorithmic traders prevalent on the exchanges.

One solution may be to extend MX's derivatives clearing system to equities, a complicated task that is unlikely to happen quickly.

"At a high level, yes, there may be opportunities to optimize clearing models including our NGX operations, but this is all for further review," said a TSX spokesperson.