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The ASX is crying wolf in its strident bid to remain a monopoly exchange

Despite its claims, monopolies produce low-quality products at a very high cost

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WELL before the AWB scandal was exposed, in *BRW* I ranted against its single-desk wheat monopoly, provoking a letter from its then managing director Andrew Lindberg.

His letter prompted me to write "Monopoly games", describing monopolists' favourite tactics to stonewall critics. Lindberg played them all. In his letter published in this newspaper last Friday ("In defence of ASX"), ASX chairman Maurice Newman "did a Lindberg".

"Monopoly games" advised discrediting critics in the very first sentence. Lindberg said I showed "little understanding" of his monopoly. Newman, ironically, quoted Milton Friedman: "The problem isn't how little people know about something, but how much they know that isn't so."

Friedman, my favourite Nobel-prize-winning economist, was the most strident advocate of free competitive markets. He despised government protection of monopolists, believing that "every monopoly produces a low-quality product at a very high cost" and "the problem is how to keep government from setting up monopolies".

Newman emulated Basil Fawlty ("don't mention the war") in ignoring compelling evidence that Australian exchange and other fees are massively higher than in markets that expose exchanges to competition. He claimed fees "pale into insignificance compared to market impact costs" — leaving the impression that we enjoy low market impacts. Evidence shows they're higher.

Credit Suisse's Peter Yuen calculates "total execution costs", incorporating bid/ask spreads, fees, market impacts and other costs. On $US1 million ($1.1 million) trades, Australia's total cost disadvantage versus the US is 35.3 per cent. Spreads are 7.94 times higher. Fees and market impact costs are 80 and 87 per cent higher, respectively.

This makes a mockery of Newman's assertions that the ASX is "low-cost", "world-class" and produces "lower costs of capital for all".

Newman says the ASX deserves credit for being the world's eighth largest exchange. Apparently, this has nothing to do with compulsory superannuation and the fact that few other exchange monopolies remain.

He asserts that "empirical analysis clearly shows liquidity begets liquidity" to justify the monopoly, equating ASX's size to market liquidity.

Liquidity — the ability to trade shares quickly — is vital. But the ultimate tests of liquidity — spreads and market depth — show we're third-rate.

Execution costs are driven by total market liquidity, not one player's. Compelling empirical evidence shows competition directly cuts execution costs, attracting liquidity and reducing execution costs further.

Three players hope to compete with the ASX. Chi-X is an electronic communications network (ECN) — a price-quoting electronic trading venue. AXE and Liquidnet, electronic block-trading venues (BTVs), handle large transactions between institutional investors and "crossings" between brokers. AXE will also operate an ECN.

Both venue types prosper overseas by serving different needs of different investors better than "one-size-fits-all" exchanges.

US Securities and Exchange Commission director Erik Sirri says "competition among diverse venues is a tremendous strength", citing "substantial improvements in market quality", including spreads and depth.

The ASX complains that competition impairs liquidity and transparency. ECNs enhance liquidity without harming transparency. Now-standard technologies let investors view on PCs real-time bids/offers consolidated across venues. "Smart-order routers" direct orders to the best deals.

ECNs even benefit traditional exchange customers. They force exchanges to lift their games, while trader arbitrage between venues keeps prices in line and lowers spreads.

As the NZ Stock Exchange half-owns AXE, a study of competition in The Netherlands between its former monopoly (NSC) and the London Stock Exchange's ECN, Eurosets, is enlightening.

It found that total market liquidity "significantly deepened" because "competition reduced trading costs". NCS halved fees when Eurosets entered. Even NSC's depth increased, indicating a "strong elasticity of liquidity to fees". Higher liquidity reduced spreads and market impacts.

The ASX warns that BTVs deal in "dark liquidity" (price quotes aren't displayed), reducing transparency and liquidity. The SEC's Sirri rejects this, saying traditional exchanges offer substantial undisplayed liquidity. Crossings represent 31 per cent of ASX trade value.

The ASX also permits "iceberg" orders, which hide depth. *Traders Magazine* says BTVs help quantify liquidity that "previously existed on blotters and in brokers' vest pockets". These low-cost automated systems match trade counterparties better than broker ring-arounds. More deal consummation enhances liquidity.

The first serious study of competition from "crossing" BTVs, published in 2006, found it enhanced London's total liquidity. While only some investors used BTVs, all investors benefited. Even LSE's spreads fell.

Exchanges facing competition have disowned earlier wolf cries. Roland Bellegarde, equity trading boss at NYSE Euronext, says: "Do we fear fragmentation? No. We are seeing not fragmentation but new volumes coming in", adding that "there is not a shred of evidence" that competition in the US raised spreads.

Competition has also made them lift their games to embrace previously damned innovations.

Trade execution speed (latency) is vital to capture the best deals. ASX's new trading system's latency (20-30 milliseconds) is pathetic. Chi-X's is 2-5 milliseconds. Many exchanges have cut latency to counter ECN competitors. LSE's is now 6 milliseconds.

Bellegarde admitting that Chi-X improved European spreads by quoting prices to three decimals, so he's moving to four.

They even embracing dark liquidity. Bellegarde says an exchange "can be more than just an order book. Many market participants, such as pension funds, don't do small trades".

Despite professing saintly concerns for the public, Newman says the ASX isn't really against competition.

But Friedman warned we should treat vested interests' claims with scepticism.

Newman warned that "critics should be careful what they wish for", as "once fractured, it will not be possible to restore the world-class market". Evidence comprehensively disproves his premise.

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