

Piecing together market fragmentation

The equities trading arena is going through a period of dynamic growth and restructuring. Once dominated by their primary exchanges, markets in the US and Europe are seeing a proliferation of cheap and efficient alternative execution venues, provoking unparalleled business opportunities for investors and intermediaries of all descriptions. Market participants seeking to flourish in this ever-shifting environment though will require the support of a partner with the vision and innovative solutions to help them stay ahead and seize the opportunities arising from market changes as they emerge, says Citi's Tom Isaac.



Tom Isaac, Global Head of Financial Institutions Client Sales Management for Intermediaries, Global Transaction Services, Citi

Trading venue choice and the competitive benefits it creates for market participants has become a central feature of the equities environment. In the US, a combination of regulatory initiatives and market forces have driven several phases of venue consolidation and expansion, such that today the New York Stock Exchange and NASDAQ compete for trading volumes with close to 80 different execution destinations. These comprise various flavours of electronic communication networks (ECNs), publicly-available "dark pools" and broker crossing networks.

"Europe is now in the early stages of a similar transformation, fuelled by the conjunction of three major forces," says Tom Isaac. The first is the introduction in 2007 of the Markets in Financial Instruments Directive (MiFID) which, by abolishing various countries' concentration rules and introducing best execution requirements, opened the way for alternative execution venues – so-called multilateral trading facilities (MTFs) and systematic internalisers (the crossing engines of broker-dealers) – to compete.

For the potential trading alternatives offered by MiFID to have a real world impact the interplay of a second factor is required: technology. To take advantage of the new MTFs and dark pools, with their promise of cheaper, faster, low market impact trading, firms need a combination of connectivity to the disparate venues and high speed smart order routing capabilities to identify liquidity and price improvement opportunities in the various pools. In this way, technology can effectively re-consolidate the fragmented market and enable participants to meet their best execution responsibilities.

On top of these developments the credit crunch is driving down the price of execution, clearance and settlement as

everyone becomes more cost conscious, while highlighting the key role central counterparties play in reducing counterparty risk in the trading cycle.

OPENING FOR BUSINESS

As a result of these changes, the emerging array of cheap and efficient alternative trading platforms are posing a serious threat to Europe's incumbent exchanges. Pan-European MTF Chi-X Europe was first to launch in March 2007, and has since captured significant market share, reaching a high of 18.37% of the FTSE 100 on March 23 2009, according to its first quarter statistics. Other notable entrants include the bank-backed Turquoise, NASDAQ OMX Europe, and BATS Europe, whose US arm BATS Exchange accounted for 10% of the matched market share across all securities in the US in April this year.

"Overall, the primary exchanges have lost about 15 to 25% of their market share to date," says Mr Isaac. "But they have responded and are also innovating with their own MTFs such as the London Stock Exchange's Baikal." More liquidity pools – be they exchange driven, broker-sponsored or independent – are on the way too, with some 125 MTF applications in Europe reportedly now pending.

It is clear that the emerging trends in the securities landscape will have long-

"EUROPE IS IN THE MIDST OF A TRADING LANDSCAPE REVOLUTION"

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term consequences for different market members. To remain competitive, infrastructure providers, brokers and buy-side firms must meet the requirements of the changing regulatory environment and adapt as traditional market roles and business models are forced to change.

“Citi is connected to almost all the major exchanges, MTFs, CCPs and broker-dealers, providing access to all the liquidity pools available while the depth and breadth of our product offering and market leading geographic presence in 57 markets can give market participants the edge they need to succeed,” says Mr Isaac.

ARBITRAGE OPPORTUNITIES

One major consequence of the trading fragmentation is the rise of high-frequency electronic brokers, which use sophisticated algorithms to look for arbitrage opportunities arising from price differentials between the different venues. In the US, electronic market makers control significant market volumes,” says Mr Isaac. “These days the largest volume players are moving from the traditional bulge bracket brokers, to high velocity algo traders. And in Europe such firms now command significant execution volumes.”

Traditionally this community relied on prime brokers for servicing support. But increasingly they are turning to traditional custodians. The reason is the asset security custodians offer - and the ability of banks such as Citi that have a broad market presence and ongoing investment in transaction processing capabilities - to handle the enormous volumes they produce efficiently and accurately.

CO-OPETITION: BROKER/INFRASTRUCTURE CROSSOVER

Meanwhile, the regulatory and technology advances are producing a new dynamic between the broker-dealers and market infrastructures. For traditional brokers - who are contending with cost and revenue cuts courtesy of the credit crunch, in addition to an ongoing squeeze on margins - there are a number of options when determining how best to provide value to buy-side clients.

For example, should firms invest time and resources in developing smart order routers to provide access to the expanding universe of execution venues, or partner with another broker that already has the technology? Should they handle clearing in-house, or use a third-party provider?

“Current thinking is that market mak-

“INFRASTRUCTURE PROVIDERS, BROKERS AND BUY-SIDE FIRMS MUST ADAPT AS BUSINESS MODELS ARE FORCED TO CHANGE”

ers have to be both on the exchange and a clearer in the local central counterparty,” says Mr Isaac. “However, some are now challenging this view, saying they can be on the exchange, but being a member of the central counterparty is not so important.”

The exchanges have similar considerations. Not only do they face competition from the new wave of MTFs, but increasingly their broker members are seeking to cross their buy and sell orders internally, rather than send them to the exchange. In the US, “large brokers are probably crossing 70% of their execution,” says Mr Isaac.

One way to compete with this disintermediation, is to execute on their own behalf away from their exchange, using those same smart order routing capabilities. Mr Isaac says, “The biggest commodity an exchange has today is their membership, and they want to remain the first point of contact. So, for example, if an order goes to the London Stock Exchange but that same security is cheaper elsewhere, potentially the LSE could buy it on the other venue and deliver it back to their client. Citi has been working with a number of exchanges to deliver this execution capability.”

In effect the exchanges could become brokers, prospectively taking up direct membership in the alternative execution venues themselves. But at that point they will require post-trade service support. “Only through a general clearing member (GCM) capability can they get into an appropriate clearing house, and a settlement agent to transfer securities at the depositories,” says Mr Isaac.

FLEXIBLE SERVICING THROUGH OPEN ARCHITECTURE

“In this increasingly complex environment some market participants, perhaps banks dealing with retail flows or smaller

brokers, will opt to focus on their client-facing activities, and ask a transaction expert like Citi to provide them with a full raft of execution to custody services,” says Mr Isaac. “We have already seen and have been working with a number of local and regional banks to do this.”

“However, we will also see an unbundling of services across the securities value chain, as organisations - MTFs, exchanges, brokers, banks or the buy-side - look to secure the capabilities they need to quickly access their target markets, while shielding themselves from the rapid changes occurring in the execution, clearing and settlement spaces,” he says.

“To this end, we have not only brought together our Global Markets and Global Transaction Services expertise to create an integrated pre- and post-trade platform for the entire value chain, but opened up our architecture to provide services on a componentised basis. Furthermore, we have been helping our clients achieve their risk-return requirements by leveraging our execution and GCM services to secure a single point of access to Europe’s clearing houses, or we can act as the settlement agent,” explains Mr Isaac.

ASIA NEXT ON THE HORIZON

While Europe is in the midst of its trading landscape revolution, the first stages of the process are now starting to emerge in Asia too. For the time being the regulatory initiatives that paved the way for alternative execution venues to emerge in the US and Europe have not happened in the Asian markets. “Rather risk management considerations are sowing the first seeds of change,” says Mr Isaac, as evidenced by the introduction of central counterparty facilities in Australia, Japan and Hong Kong, and the emergence of third-party clearing capabilities.

“If there is no central counterparty your capital usage and risk exposure is high because you are not netting down your trades,” he explains. “But once there is a CCP and net settlement, you no longer have bilateral trading limits with different counterparties and are therefore able to increase trading.”

What is clear now is how regulation and technology coupled with the need for cost efficiency and revenue growth are driving rapid change for industry participants around the globe. Infrastructure providers, brokers and buy-side firms must adapt as their business models are forced to change. There are real opportunities for those that do. 