

The Changing Shape of the Buy-side



By **Amy Muddimer**, Director, FIX CITY

Amy Muddimer, director, FIX CITY, talks to two leading buy-side firms about how increased regulation and advances in technology are continuing to change the shape of the securities industry.

Despite fierce competition and regulatory pressures the buy-side continues to thrive by taking advantage of the latest technology. Firms face even faster change during the next ten years as electronic trading continues to gain pace along with demands for even greater transparency.

■ Managing risk

In the last decade there have been dramatic movements in market practise, the regulatory environment and technology, according to Steve Wood, global head of equity trading, Schroder Investment Management.

The latest technology has enabled firms to effectively manage or mitigate risk while driving order flow. Wood says: "The ability to communicate with the brokerage community

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electronically has become paramount. The FIX protocol has established itself as the business standard from a local and global perspective. We have trading desks in London, New

York, Singapore, Tokyo and Sydney, where over 90% of our equity order flow and execution is sent and received via FIX." Wood goes on to say that it is their FIX connectivity that strengthens Schroder's quality of execution and risk control.

The use of FIX has significantly reduced margin for error at Legal & General. Mary McCave, senior dealer, Legal & General Investment Management says: "We put a significant proportion of our order flow through FIX to our counterparties and it has helped us to mitigate risk. The intention is to move towards 100% of flow in the future, as technology allows us to connect to more destinations."

■ Buy-side takes on trading

The adoption of electronic trading and the ability to access exchanges has also enabled the buy-side to begin to take on more of a trading role, relying less heavily on the sell-side.

Wood believes that electronic trading will continue to gain pace with Direct Market Access (DMA) and algorithmic trading becoming more widespread. He says: "We put a considerable amount of business through DMA venues. The broker is the conduit for us to the exchange. This structure is commonplace at the big houses and is going to cascade down to small to medium sized firms." Wood believes the buy-side trader is becoming more empowered as a professional trader, rather than simply passing orders on.

McCave agrees that the buy-side is becoming less likely to outsource the trading to brokers nowadays. She says: "The industry will continue to change as direct access to the exchanges gains critical mass. The buy-side is looking to upgrade their skills and take on more of a sell-side approach. The days of giving your order to a broker, to work for you, are certainly over for a lot of people. Many buy-side firms want to do more of the trading and are taking more control."

However, this doesn't mean that the trader is now on the buy-side. Wood says: "The sales trader isn't dead in the water, they are just becoming specialists in block trading and adding value. We can easily work five million Vodafone through DMA, at a better quality of execution. Buying 100 million Vodafone is a different scenario and we would want the sell-side to find the other 95 million for us from their client base and help us reduce our transaction costs."

The greater use of DMA may have drawbacks, according to McCave. It requires sophisticated systems and, potentially,

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increased staff, which could be too expensive for some buy-side firms. Unless the buy-side invests heavily in IT they won't be able to match the sophistication of brokers. For the near future, at least, it doesn't look like brokers are going to disappear in a hurry.

■ Compliance

Regulatory pressures remain one of the biggest challenges faced by both buy- and sell-side firms. Firms are restructuring business and operating models around clients as a result of the Financial Services Authority's Consultation Paper 176 (CP176).

CP176 drew attention to the opaque nature of arrangements under which fund managers make direct charges to the funds they manage, by way of commission, to purchase goods and services in addition to execution. As a result, the industry introduced enhanced disclosure, which aims to provide clear information to clients about how transaction costs are managed.

Obtaining 'best execution' for the client has always been the subject of scrutiny by regulators and is further incorporated into the Market in Financial Instruments Directive (MiFID), due for implementation in November 2007.

As transparency becomes more aggressively sought by clients buy-side firms are focusing more on Transaction Cost

Analysis (TCA) as a way to distinguish themselves from the competition. Wood says: "CP176 and comparative disclosure is starting to gain pace and will begin to generate enquiries

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about transaction costs and how you trade. Also, as a consequence of MiFID and the requirement for execution policies, clients want to see that firms are getting the best price from the marketplace and are utilising all venues in order to get this. No doubt they will start to compare one asset manager against another."

McCave believes that trustees are becoming more educated about the processes necessary to ensure best execution is obtained for clients. She says: "Best execution is about following a transparent, clearly defined process to ensure you obtain the best possible result for your underlying client."

■ Increased fragmentation

As the market continues to fragment, with competing exchanges and new execution venues, it is increasingly important for buy-side firms to be able to access multiple sources of liquidity.

McCave thinks that while liquidity is increasingly fragmented, it is not necessarily a problem. The ability to access different liquidity pools could become a competitive advantage for buy-side firms. She says: "It's imperative for the buy-side to have an armoury of tools for dealing, to be made use of where appropriate. For example, recently we have seen a rise in the

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number of buy-side firms entering into a 'reverse enquiry'. We ask a broker to commit capital to place a block of stock, on our behalf, where there isn't a lot of liquidity in that name, and where, trading out of it in the market in a traditional way over several days may impact the market."

There hasn't been a significant move, as expected by some, towards dark pools of liquidity or a substantial increase in the use of ECN's. According to Wood, ECNs have gained some

traction in the US but remain on the periphery in Europe and Asia. He says: "Crossing networks haven't really gained critical mass, although they have become more dynamic, moving from static crosses at a fixed time to dynamic crossing interacting with the asset managers OMS."

This could change. Wood says: "MiFID will help their cause, as you have to try to tap every pool of liquidity. If people don't include crossing networks in their policy, the clients are going to be asking them about that. So that could be a useful catalyst in Europe for them. It wouldn't surprise me if in 10 years time they had a large part of the market share."

Brokers are combating the growth in ECNs by improving the quality of Indication of Interest Messages (IOIs). Wood says: "IOIs have become more robust and accurate. Essentially

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each IOI sent out by a broker is a little crossing network in its own right. Brokers are still the centralised pool of liquidity or have the ability to pool the liquidity."

■ Global strategy

In addition to becoming more client focussed, operating models are increasingly looking to build a global trading strategy in which transparency is key. Wood believes that we will see increased unbundling of services in the future on a global level. "There will be a Mexican Wave scenario around the world, for example Australia is already looking very keenly at it. Commission sharing agreements, on a global basis, will be standard in the next four years," he says.

The use of technology and market consolidation will continue to globalise the investment trading process. Wood says: "The consolidation of the big exchanges means market practices will become more level. For example, in Europe, dealing on the London Stock Exchange or EuroNext is roughly the same. The ability to tap liquidity on a 24-hour basis will also become more prevalent. If you are trading BP when the bell rings at the London Stock Exchange, you can move to trading it on the New York Stock Exchange for example."

Wood adds: "The ability to get into exchanges globally is a lot easier than it was five years ago, and the deregulation of markets going forward will speed up. Places like Korea and Taiwan are taking steps to become more open and easier to trade in. Places like Poland, Hungary, Cyprus and any other country that becomes part of the European Union (EU), will come under the EU regulatory bodies and regulation (MiFID)."

Expanding into new geographies will provide attractive growth opportunities for many firms. In particular, emerging markets are providing new sources of revenue growth as investors become more sophisticated.

In future, whatever a firm's size, seizing emerging growth opportunities will require deeper client relationships and a greater focus on innovation. Transparency and speed will continue to drive firms to modify their operating models in order to manage risk and optimise efficiencies on an increasingly global level. **FIX**



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