

Changing Times



By **Peter Randall**, Director, Instinet Chi-X Limited

A potent mixture of regulatory change, technological advances, customer demand and FIX adoption are currently combining in Europe to herald the biggest changes in equity market infrastructure in a generation.

The Markets in Financial Instruments Directive [MiFID] removes the concentration protection enjoyed by some European markets, it also makes 'best execution' mandatory and controversially provides for radical changes in the disclosure process. The implications of these changes are significant. Under MiFID, European Banks will be able to internalise flows, European Asset Managers will have enhanced best execution responsibilities and the regulatory door for competition at the central market infrastructure level has been firmly opened.

The inexorable logic of Moore's Law works both ways, if price falls and capacity increases from the perspective of a potential purchaser, then from the point of view of an incumbent provider, a recently specified platform is going to have both price and capacity advantages. The incumbent European Exchanges have round trip latencies of between 125 and 300ms, the ones that publish their gateway capacity advertise a flow rate of between 65 and 650 transactions per second. The prices that are offered are all clustered around 0.5bps for an order book execution. Stock Exchanges in addition are probably

the only business models in the world that charge their customers to look at the price list, as Market Data is a very important source of revenue.

Customer behavior is changing rapidly in Europe. Reflecting the best execution requirements of the buy side, many sell side firms (either telephonically or via

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algorithms) now send many more, much smaller bargains to the exchange. This development is the current driver behind the recent record profitability reports tabled by the leading European Exchanges. Customer business models are changing rapidly as well, specifically the High Frequency Statistical Arbitrage Market Makers are further

refining their models to capture the residual inefficiencies within the European Market Model. These customers, together with the traditional Investment Banks are demanding lower prices, faster access and higher capacity from their trading destinations. The Exchanges, stuck with their legacy technology, high cost base and slow gateways are finding the competitive landscape increasingly challenging. The irony of record profitability coupled with significantly altered customer demands is a hard pill for the existing providers to swallow.

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FIX adoption, by the leading participants within the principal European equity markets is now at an increasingly mature level for the first time since the introduction of the protocol. It would be fair to say that the majority of 'professional' participants with an interest in trading European equities are now 'wired' into a fairly high version of FIX, with FIX 4.0 and 4.2 being most common. This new found level of standardisation and connectivity is starting to provide the base for a new round of financial market innovation both on the trading side through 'Smart Router' initiatives, or on the asset management side through 'TCA' and better analytics. The bulk of these products are now delivered using standardised connectivity.

Against a background of unfulfilled customer demand, regulatory change, technological progress and FIX enabled trading participants, the opportunity for structural change in the European trading environment is very large. It was this concentration of factors that led and is leading, to firms like Instinet to seek to offer competition to the established and incumbent European trading infrastructure. The opportunity lies in offering a very fast trading platform, at a much lower price than the incumbent exchanges coupled with a very large gateway capacity which is very easily scalable.

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It is important to study the landscape of past initiatives attempting to establish fully electronic, Pan European, alternative trading destinations, to see what lessons could be learned. The central point was that a common feature

of previous systems had been their lack of an industry standard connectivity protocol. The widespread adoption of FIX across Europe, particularly amongst the sell side and the more technologically advanced hedge funds and buy-side shops means that this problem has now gone away.

The opportunity to benefit from a combination of disruptive technology, coupled with very competitive pricing is now being demanded by the majority of European traders. The biggest challenge for alternative Pan European trading venues is to attract liquidity, which we, at Instinet Chi-X, see in part being accomplished by enabling existing market participants to post flow on a very fast, very high volume platform and allow them to run their arbitrage models against the incumbent exchanges. A more compelling reason to deal with any new (existing or future) alternative destinations will be the considerable price savings that inevitably have to be available.

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