



## Changing the way we work



*By Peter Hermans, Head of Continental Europe, Instinet Europe Limited*

**The appetite for new technology has changed dramatically over the past few years. Connectivity between the investment manager, execution desks, brokers and the back office has become essential. Some four or five years ago, buy-side firms made significant investments into setting up their own internal systems to enable investment managers to pass orders to traders.**

Once the internal processes were automated, the next logical step was to automate the communication between the buy side and sell side to reduce what was often considered a slow process, open to manual errors. The need for a common global language saw the birth of FIX.

FIX has encouraged the use of a universal standard to improve workflow efficiency. And as market participants have moved towards eliminating as many manual processes as possible through implementing straight through processing technologies, so FIX has formed a significant part of that toolkit.

## The evolution of FIX

What began as a vision between Fidelity and Salomon Brothers has grown to a global protocol. The venture, which began some ten years ago, has expanded from a system that merely supported equity orders and trades, at its inception, to a global language for trade-related messages across all asset-classes. This global language now automates the entire trade lifecycle including pre-trade, trade and post-trade. This is a significant achievement. However, the industry has more work to do to encourage smaller buy-side firms and hedge funds to embrace the common protocol. Although FIX is relatively quick and easy to implement, the buy side are often touted as stragglers in the adoption of new technology. The apathy of some of the smaller firms towards embracing FIX may be attributable to some extent to the fact that investment managers process lower volumes and therefore have less impetus to achieve the efficiencies afforded by FIX. The benefits, however, are clear. In an era of increasing regulation and dwindling profit margins, FIX has huge potential to help firms to lower costs and comply with growing industry requirements. As “transparency” becomes the latest buzzword, the ability to provide an electronic audit trail becomes ever more important. Investment managers and brokers are increasingly able to use technology to analyse market data and to measure execution quality, transaction costs and processing capabilities.

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Indeed, at a time when risk management and compliance are essential, FIX incorporates the necessary checks and balances to reduce over-trading and eliminate manual errors, helping firms meet compliance standards and reduce operational risks.

## What has driven the global adoption of FIX?

A number of factors can be attributed to the successful adoption of FIX. However, none is more important than the overwhelming need for greater efficiency. It is widely known that FIX lowers the cost of trading by automating the entire trade lifecycle. This efficiency in turn helps to drive down

costs - an obvious benefit for the end-investor and an ever more important benefit, particularly in light of the industry's desire for greater transparency and accountability.

Regulation has changed the shape of the market and continues to effect change. From a buy-side perspective, the new European securities law, the Markets and Financial Instruments Directive (MFID), agreed on 30 April 2004, requires in Article 21 that every firm has an execution policy. This even applies to investment managers! Those investment managers who are currently FIX-compliant are able to connect to any number of brokers in a standard format, making it easier and more cost-effective to define and implement an execution policy. An investment manager who is therefore not entirely satisfied with the broker he currently uses can quickly change to another broker that does meet with his particular execution strategy. Through the use of FIX, the implementation process can be achieved quickly and easily without the need for new systems or new hardware. Transaction costs are vastly reduced as, firstly, investment managers are able to select brokers that focus on delivering the best execution possible and, secondly, it removes the need for additional costly bespoke system developments, a cost that may be reflected in the overall performance of the fund or the firm.

## How the sell-side has evolved

Whilst thinking about the content of this article, I was reminded of many anecdotes to demonstrate how our industry has evolved over the last few years. One in particular springs to mind, which I believe illustrates the true value of FIX.

An investment manager would have called in an order with 15 buy and sell orders across Europe - 15 names on each side. These 30 orders would be verbally passed by phone and then repeated back to the client to ensure there were no errors. The orders would then be entered into a spreadsheet for monitoring purposes - consider the time implications and probability of errors! The broker would be required to trade the order between 2.30pm - 4.30pm and the investment manager would want the order to be percentage-complete at any point in time.

What would now be considered a simple trade provided much entertainment for colleagues on the trading floor. To execute this order was no mean feat. It required the services of two sales traders, manually entering orders into the

system (one buy order and one sell order) and on top of that manually calculating the percentage ratios on a calculator! Two hours of intense, uninterrupted concentration ensued with one or other of the traders randomly shouting 'hit' to ensure both sides of the trade were being executed at exactly the same time. The result was an interesting display of life before FIX.

Much has changed. Long-gone are the days when brokers spent hours telephonically substantiating order information. Client relationships have evolved beyond time-consuming administrative discussions. Trader productivity has increased as a result, freeing up their capacity to handle larger volumes of orders. FIX has not only improved trader efficiencies, it has also seen the development of new sell-side initiatives.

The most notable of these initiatives has been the growth of Direct Market Access (DMA) - the capability for a buy-side trading desk to send orders directly to an execution venue without the involvement of a sell-side trader. FIX has thus provided the buy side with a gateway to the sell side's internal trading tools. As regulation has called for greater transparency and accountability, so investment managers have sought technology that provided them with control and access to real-time information. DMA provides this visibility. According to a recent Edhec-Risk Advisory survey, of the 150 European investment management institutions surveyed, 66% of respondents intend to increase their DMA volume over the coming years. And, as DMA becomes more widely available, so sell-side firms will need to differentiate their offering and provide value-added services. The recent growth of algorithmic trading is evidence of this differentiation as brokers bundle sophisticated trading strategies into their DMA offerings, so that buy-side clients can send more algorithmic trades via FIX.

In addition, where business used to be won and lost on the basis of an institution's front end, this is no longer the case. FIX has increased the sell side's reach to the buy side, as investment managers can now connect to their broker of choice through the front end of their choosing.

For those sell-side firms that have not embraced FIX, the opportunity cost is substantial. Manually inputting order information is extremely time-consuming, the result being that the market may move away from the trader to the detriment of the client.

## What is next for FIX?

The current version FIX 4.4 provides the ability to send FIX allocation and FIX confirmation messages. To date, this has been implemented on a sporadic or ad hoc basis and we see global adoption of FIX 4.4 as the next chapter in the book. Until recently the use of FIX has predominantly been focused on the execution aspects of the trade lifecycle. However, as the cost of execution has come down over the last few years, institutions now need to focus on the next facet of their business that can be improved. At many firms, the back-office systems may be over 30 years old and the confirmations and allocations process remains labour intensive and costly. This is just as critical an area as executions and requires the same degree of attention in order to achieve true Straight-Through Processing. This will help to remove many of the root causes of settlement failures. The adoption of the latest version of FIX will take place at the speed of the market. Unsurprisingly, declining profits impact the level of investment in technology. However, it is important to remember that technology enables greater operational efficiency and although the initial investment may be costly, through economies of scale the level of investment will reduce as the industry standardises.

Whilst originally born out of the US, FIX has become a global phenomenon. Asia, although initially slow to adopt the protocol, has caught up quickly in recent years. Europe has seen slightly slower uptake than Asia. However, with the impending regulatory pressure from European legislation (MFID), we expect increasing growth in FIX usage across Europe as investment managers turn to technology to help them meet both their clients' and the regulators' demands for greater transparency and accountability, and to meet the end-investor's and regulators' tougher best execution requirements. The successful use of technology may well be the litmus test that defines the progressive investment manager of the future. **FIX**

### **Any thoughts on this or other articles?**

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