

## Delivery of client's services in a fully FIX environment: A brave new world!

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**Electronic access to markets has revolutionized the delivery of services to clients. Brokerage firms are being forced out of their product solos into consolidated service groups in order to respond to client demand for integrated products.**

As execution becomes more and more standardized through screens or through protocols like FIX, firms are turning to post-execution services to add value. Today a large brokerage firm's client services offering includes an electronic execution platform with sophisticated trading tools, an indication of interest system, as well as margining, financing, allocations, processing systems, and sometimes even administration and booking tools.

But firms are facing stiff competition from exchanges and service providers as cheaper technology, standardized protocols and easier access to markets have given all players the capability to offer services once the exclusive domain of brokerage firms and banks. Is the future market structure across asset classes going to be one or two data providers, a few exchanges and a few brokerage houses all competing to offer the same services to the same clients? Who is going to take the lion's share of the customer pie in the future? How should client services be delivered in the post electronic revolution world?

### **What is the likely Evolution of the Market post FIX?**

The first wave of electronic trading was all about basic access: access to more exchanges, clients, brokerage firms,

and asset classes. Now that access has been achieved, clients are taking a step back and reviewing the services they receive from brokers, data providers, and trading platforms and analyzing whether the services offered match their needs. The market is still very much a "push" market where the client takes whatever technology the brokerage firms and banks have built, purchased or cooperated on, which does not necessarily meet the new needs of the clients. Beyond the delivery of a screen, client needs today extend to asset class and market integration, a new generation of trading and market data tools and bundling of clearing services.

- **Asset class integration.** Perhaps the most important element in the electronic trading evolution is the move toward integration of listed derivatives, cash and foreign exchange trading. Advances such as streaming prices in bonds and foreign exchange and a standard protocol for equities have made this process feasible and profitable for all parties. With sophisticated clients being more and more strategy driven in their approach to trading, it has become essential to offer the various legs of the trades in the same "counterpart" environment. Although most big firms have been organized around product silos,

various divisions are now teaming up to offer multiple asset classes on the same platform, potentially with single financing and margining capabilities.

• **Progressive market integration.** The second factor influencing the new market structure is the progressive erasure of the differences in trading patterns. For instance, there is less and less difference between the trading approach for a product which trades in an order book, but where large quantities need to be gathered and executed through blocks, versus another product whose market is maintained by a few large banks which take relatively small trading positions and split the risk through inter-dealer brokers. In addition, the various sources of liquidity (brokers, exchanges, locals) are beginning to compete with each other for direct access to clients instead of sticking to their previously defined role helped by standards like ISIN and FIX or FPML.

• **Development of second-generation algorithmic trading tools.** The great success of integrating algorithmic trading tools into existing platforms has reshaped the services offered to clients. Clients now demand sophisticated algorithmic trading tools to search for price discrepancies and measure trading results. Complex trading strategies like Volume Weighted Average Price (VWAP), Smart Order Routing or Pair Trading are now as easy as buying or selling. In addition, the highly successful development of strategy engines which allow clients to build their own set of strategies on top of basic order routing has created a whole new world of opportunities. Strategies which originated on the equity side of the business are rapidly impacting other asset classes including listed derivatives.

• **Bundling of clearing services.** Finally, maybe the most significant of all recent trends is the bundling of clearing services. While the execution side of the business is quickly making its way to the 80% fully electronic and 20% facilitation plateau, the main clearing advance has been to display a statement on a screen. This falls far short of what the client wants. The client is looking for a real “fire and forget” offering-automated risk-based credit checking, margining across asset classes whenever possible, automated allocation, real-time account statements, and connection to backend systems. While many of these features are now being offered, as clearing moves more and

more center stage, clients will expect these services to be part of the standard clearing package offered by intermediaries.

## What is the impact of these evolutions on the Value chain of the brokerage industry?

As shown in the chart overleaf, the traditional value chain, based on research, discretionary execution and basic access to markets, has been affected in an extreme way and will evolve around the three following poles of revenue generation:

### • Value added execution services should be split in the future in 2 different segments:

#### • Trade facilitation

In that segment, trades to exist need to be “organized” by brokers. This means organizing block trades to capture unseen liquidity, to offer financing or cross margining capability for instance. This segment will stay very important and will eventually grow with more matching taking place and liquidity being split among more participants. Market knowledge, client coverage and capacity to commit transitory capital are the key success factors in this field.

#### • Algorithmic execution services

This relatively new field is bursting with initiatives and creativity. Brokers are retooling some of their successful electronic strategies and packaging them for their clients. This will continue to grow and the offerings will be widened based on the great quant capability of brokers. The success factors here are quality quant work, speed of infrastructure and distribution.

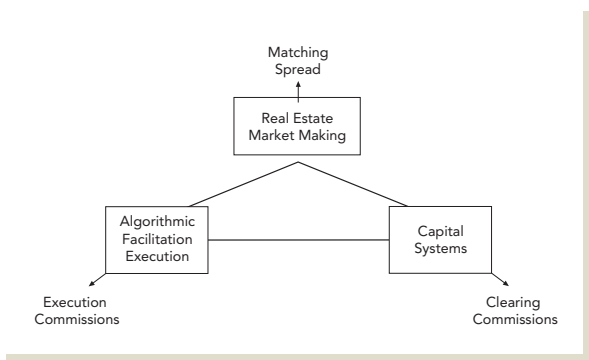
#### • Matching

With the natural evolution of the compliance and regulatory environment towards a less monopolistic approach to market organization, competing pools of liquidity should flourish and brokers should be allowed more and more to internally match flows that they have captured through their marketing efforts. This potentially creates issues in the areas of transparency and best execution but also offers advantages in terms of facilitation of large trades and discretion. Brokers will enjoy a spread revenue on these transactions. The success factors in this highly sought after area are “real estate”, meaning the number of clients hooked to the

broker offering, and the quality of the intermediation provided in terms of speed of execution and spread.

## • Clearing services

Finally the anchor and maybe the most stable part of the business, even if it will go through a significant rebuild, is clearing. Simplicity, risk based margining and quality of the reporting and accuracy of the settlement will be the key to a successful bundling of services with the execution capability. The success factors in this area are capital and systems capability.



As research is increasingly delegated to independent providers, and clients concentrate increasingly on the quality of their execution and clearing process, successful firms will position themselves along these poles of competence: Value added execution, Matching and clearing services. A few firms will manage to offer all services successfully but most will focus on one of these areas and will become specialists with an indepth offering in their specialty.

## What is the impact on the people working in this business?

In the new environment that we face, where the 80/20 rule applies (80% of trades are fully electronic and 20% of the trades still require manual intervention), the future for the people in the industry appears clear. This future follows the same evolutionary path which has accompanied any other significant technology revolution across the centuries:

- **Be on the winning side of the revolution:** As demonstrated by the wholesale development of the connectivity groups across the industry and the development of dedicated technical teams supporting

the new approach to the market, this evolution creates as many jobs as it takes away. Personnel have to adapt to a different set of skills but the resulting jobs are usually more rewarding.

- **Develop capabilities on the 20% of trades being facilitated:** Electronic trading brings a lot to the market but does not qualify as a 'catch- all' for sophisticated transactions. While in some markets you are unable to trade manually nowadays, due to the speed of the market, there are a lot of instances where manual orders deliver added value. For instance, with very large orders, clients still like the judgment of an individual, compared to a system, and will very often continue to pass the trades orally. In addition, exchanges are very often only the tip of the iceberg in terms of liquidity and as especially proven by the option market, sales traders can synthetically create a market depth nonexistent in the market place and generate a block trade. Finally, for some, trade facilitation will be necessary, involving capital commitment or funding. Today, this is still today managed better through a sales trader.

There is no easy solution for developing and delivering services to clients. Leading players are constantly reassessing the new trends and their impact on the services necessary to bring value to clients. For the financial services industry, it means developing the right metric of analysis to build and deliver the right service, at the right place, at the right time and at the right price. This is the tough equation facing all players and their technology partners in the coming years, disregarding existing and potentially outdated classifications. Client focus, client commitment and integration of services will be more than ever the key to survival and successful evolution. In the same way that "just-in-time" inventory control revolutionized industrial logistics and allowed some industrial companies to break away from the pack, an "out-of-the-box" rethinking of the delivery of services in the financial services sector could yield a significant competitive advantage for the firm that gets it right. **FIX**

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