



IOIs - Indication of Interest or it's only indicative?



By Amy Muddimer, ioinet Sales and Marketing Director, FIX CITY Ltd

Reliable, top quality, “real” IOIs will be found high on the wish list of all serious dealer/traders. The trouble is, that by the time you catch them, you have missed the boat or the world has changed. This article explores the IOI and some of its challenges, and closes with perhaps a new perspective.

Executing large orders

When a fund manager makes a decision to acquire stock or offload a holding, the dealing desk is given instructions on how quickly this should be effected and what the targets are. It is the responsibility of the dealing desk to formulate the dealing strategy and communicate back any challenges

faced. The dealing desk will be seeking to meet the fund manager's expectations and wherever possible exceed them.

Dealing is a cost impacting fund performance. Dealing in illiquid situations where sizes are large or the stock thinly traded brings additional challenges. Information leakage

can result in additional cost and lost opportunity. An effective dealing desk can offer flexibility, reduce dealing costs and make a valuable contribution to an investment firm's performance.

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What are IOIs? (A bit of background)

Originally an underwriting term, IOI used to mean the indication of interest in a new securities issue. It has evolved over time to become a term meaning the indication of interest in a security, whether a new issue or an existing one.

Brokers send IOI messages to their clients; this information is sensitive and distributed discretely, often targeted at firms with a known interest in the stock. This approach to information dissemination from the sell-side helps to minimise leakage, maintaining the competitive landscape. The buy-side can view the information passively. The dealer can formulate strategy around the incoming information without having to reveal a position. The IOI message itself is not binding, but provides an opening indication to support negotiation. In effect, IOIs help the buy and sell-side match bargains.

Initially, IOIs were communicated by phone calls where dealers would have to listen to numerous brokers summarising bid and offer lists whilst attempting to pinpoint relevant pieces of information. Faxes were then used as a way for brokers to send many clients information in a single process. Dealers could receive fifty or more faxes up to three times a day, none of which would be uniform in terms of presentation. The process was very inefficient, prone to error and lost opportunity. Additionally, owing to the time-sensitive nature of information, it was impossible to keep indications of interest up to date. In 1969, the first electronic IOI distribution systems were launched.

Today brokers send thousands of IOIs throughout the day, keeping their clients around the world informed about their positions.

Why are IOIs such a big deal?

When talking to a number of our clients, (large global brokers, smaller niche players, institutional investment managers and hedge funds), the consensus is that IOIs are a big deal.

In these times of highly volatile markets, with average size decreasing, and the push to find the elusive pools of hidden liquidity growing, brokers send thousands of IOIs per day to their clients, and clients receive thousands from each of their brokers. An estimate of the number of IOI messages received by a global investment manager running a 24 hour operation is between 90,000 and 120,000 messages per day. It is no small task for the client to make sense of this huge amount of information, hence the significant number of varying solutions to help them.

One global broker told us they estimated that they received 90% of their business in response to IOIs. Many brokers do not have any way to determine the exact figure, therefore, they rely on the instinct of the sales traders, to tell them whether this means of "advertising" their business is successful.

On the buy-side, IOIs are equally as important in deciding where to place orders. It is far more productive for a dealer to make only one telephone call, exposing their order to a broker whom they already know has an interest in that stock, than to ten brokers to try to find the liquidity they seek.

With today's growing emphasis on being able to prove best execution and minimise market impact, the ability for the buy-side to see which broker has some liquidity in the name they need to trade is invaluable.

What is wrong with this picture?

Under pressure to find the next order, brokers sometimes test the boundaries of what they can gain by issuing unsubstantiated information in their IOIs. If a client opens up, the broker could win the business simply because the risk of further leakage outweighs any advantage of going elsewhere. However, the client has almost certainly lost the opportunity of gaining the best execution at that time.

Many of the IOI messages have been known in the past to be unwanted probes from brokers. The image of IOIs has never been particularly pure. Brokers “fishing” for information will send IOIs even if they have nothing to trade at that moment. This continues to be a problem, with buy-sides increasingly unwilling to expose their position if the broker is not seriously interested, but rather just probing to try and find out where the natural liquidity is in the market.

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Technology

Brokers have a variety of solutions for generating IOI information. The issue for them is reaching all of their customers, placing IOIs where their clients want to see them, efficiently. The buy-side is a fragmented space in terms of dealing desk technology, therefore meeting every client's expectations takes careful management. Some vendors accommodate IOIs, others do not.

The FIX protocol has helped the dissemination of IOIs enormously. The adoption of a common protocol has driven away the need to develop proprietary systems lowering integration costs and providing for system interoperability. Further, it has re-invigorated the competitive landscape, such that brokers and their clients now have access to richer functionality than was previously being provided.

Through the latest innovations in this area of dealing technology, brokers can now send their IOIs to their buy-side clients knowing that if the buy-side dealer has an interest in that name, they will be pro-actively alerted to the IOI coming in. In addition, buy-sides can receive their IOIs via FIX in a feed that will intelligently filter and re-send any IOIs which are of interest after the IOI was initially sent.

Brokers can send their IOIs in any version of FIX. Their buy-side clients can receive IOIs in the FIX message version they have chosen, freeing the broker from the burden of maintaining systems sending IOIs in multiple FIX versions.

Smaller brokers who have not yet fully established their FIX connectivity can manually key in or upload their IOIs,

and their buy-side clients can receive them over FIX messages if they wish to see them in that manner.

Clients can take FIX formatted IOIs from multiple brokers from a single vendor in a normalised feed to suit the capabilities of their Order Management System (OMS). The buy-side OMS can now be supplemented with simple intuitive links to specialist vendors with rich functionality that builds the dealing strategy. The specialist applications now provide charts and graphs to help dealers analyse liquidity profiles, further refining their strategies and helping them realise even better executions.

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Nirvana

It has often been thought, certainly on the buy-side, that “Nirvana” in terms of IOIs would be for the OMS to identify those orders on the blotter for which IOIs have been received, and to be able to turn that IOI around and send out a FIX order, referencing the IOI identifier, so that the broker knows that the IOI was important in the generation of that order.

As increasing numbers of buy and sell-sides have FIX capability, so the drawbacks are becoming apparent.

The huge number of IOI messages received by the buy-side into their OMS and through their FIX engine for names which are of no interest has necessitated the OMS vendors to filter the IOIs, generally discarding the messages which will not match an open order.

This is fine, until you think of the scenario whereby the broker sends out their initial IOI list in the morning, and the fund manager inputs an order at 10am, and the match does not occur (unless the IOI is refreshed at regular intervals).

In fact, any method of filtering the IOIs in this manner endangers the use of the ad-hoc fund manager call over to the dealing desk to “keep an eye on” a security.

Also, every buy-side has at least one or two smaller, more specialist brokers that they trade with, who do not yet have the capability to send their IOIs out to clients via FIX. Where do they fit into this equation?

Perhaps this 'traditional' view of nirvana does not fit with today's real world. So where do we go from here?

The future

We can see a number of business drivers. For the buy-side they include, paying for the services they consume, having to demonstrate 'best execution' and an even greater effort to improve margins beyond stock selection.

FIX CITY feel that these drivers lead to demanding more from vendors and brokers with emphasis on making IOIs work harder and smarter.

As specialists in the IOI arena, FIX CITY is seeing growing demand from the market for more advanced services, including the ability for the trading community to directly relate costs to their trading process and charting of Trade Advertisements from brokers to show which brokers have been active. This information complements IOIs and in illiquid situations can be the most relevant guide for the dealer.

Some IOI distribution services are priced on a per message basis, so the prospect of sending out IOIs to multiple groups of clients is not a cost-effective option

There has been a lot of discussion in recent months about "hittable" IOIs, what this might mean, and how such a thing would work. The ability to turn an IOI into an order is certainly something the buy-side is keen to see. But why has this not happened yet?

One reason is that for this to become reality, the broker would need to be able to specifically target the clients they wish to send their IOIs to, at a particular time, and not have their position visible to all clients at the same time. This would mean sending the IOI message out multiple times.

Some IOI distribution services are priced on a per message basis, so the prospect of sending out IOIs to multiple groups of clients is not a cost-effective option.

However, the buy-side are not as happy as before to receive "broadcast" IOIs because they know that quality will not improve unless the sell-side are in a position to use the full flexibility of an IOI service without having to look at the bill at the end of each month and question whether or not they are receiving good value.

The broadcast approach also makes life easier for those unscrupulous brokers who send unsubstantiated IOIs. It is far too easy to be able to say "Oh, sorry, someone else just got that", "You were just too late", "But we can try to work the order for you?" By which time, the buy-side has exposed their position!

In response to these issues, at FIX CITY we believe the future lies in giving flexibility to the brokers so that any liquidity marketing strategy can be accomplished.

Thus brokers are able to target single clients and set up intelligent sequences to cascade an IOI through their clients giving sufficient dedicated time for each to respond to the broker, if they have interest in the name, before the opportunity passes on to the next buy-side in the broker's priority list. Of course they can also broadcast an IOI if that is the appropriate route to getting business done.

We see that through targeted and cascading IOI functionality, sell-side and buy-side can work together to enable the buy-side to send an order off the back of the IOI they have received. The buy-side know it will be accepted and that they will be in exclusive negotiation around a real position. If not a "hittable" IOI, then at least this is "firm" with a guarantee of liquidity. **FIX**

Any thoughts on this or other articles?

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