

Pablo Garmon, European business development manager, TAG (Transaction Auditing Group, Inc.) Europe, provides a personal insight into what the future may hold.

What's next, fragmentation or consolidation?

New regulations have allowed for the creation of new venues. Some have done well from the start, some have started promisingly and others still have to prove themselves. Most players are now convinced that their motto in the forthcoming months will be “search for liquidity”.

At the recent World Federation of Exchanges conference, I had the opportunity to investigate a panorama of executing venues and identify the factors behind this quest to attract liquidity. They include:

- Technology – speed, capacity, creativity
- Functionality – new types of orders, creative routing systems
- Costs - access, trading, clearing, settlement, smart order routing, rebate models

Some liquidity from the newcomers is “new” because before the millisecond era abundant amounts of algo trading were simply not possible. There is also “Arbitrage liquidity” which originates from having the choice of several venues, but the technology necessary to play in this field is very costly and only for the big players. However, now with new competition the cost of trading has decreased.

One driver that is here to stay is that there is plenty of order flow for Institutional and Retail markets.

- Institutional – prop trading, market making, private banking, traditional asset management.
- Retail – according to the volume of orders and the size of those orders, it can generate several types of retail order flow. That order flow has its own features and constraints,

and will look for execution venues that best fit their needs.

Also, the impact of MiFID isn't over just yet. Recently, the newcomers have announced the roll out of dark and lit pools Burgundy, Quote MTF, Baikal, and NEURO Dark. Most of the current main markets have already launched their MTFs, whether displayed liquidity or dark. The main reason for platform promoters to segregate their displayed order book from non-displayed is the reluctance by regulators to mix large dark orders with displayed liquidity, especially orders pegged to the midpoint of the displayed main market EBBO. This is nothing more than playing by the rules as MiFID encouraged the appearance of new players to break the concentration of order flow. In order to protect investors, MiFID also put in place mechanisms to make ‘boys play with boys, and girls play with girls’.

If we look at the falling market volume numbers though, not many of these new platforms will continue to ‘catch’ revenue, either from their founders or from new investors. There are several scenarios that could play out in the near future. One initial observation runs contrary to all expectations. There are only 11 official Systematic Internalizers (13 in total since UBS and Citi have 2 each), when many market participants had expected more, but regulatory frameworks and small differences between SIs’ and MTFs’ lead promoters have limited the creation of new venues.

THE FUTURE?

No doubt, after the initial fragmentation phase a consolidation phase will occur. But when will consolidation occur and how deep will it run? And can we be sure we're still in the

fragmentation phase? In an article published in the October 2008 issue of Best Execution magazine, TAG welcomed the new venues, and stated that real competition will happen when the main markets compete amongst themselves. Recently, NASDAQ OMX and NYSE Euronext launched their own MTF dark and lit pools. LSE is also launching Baikal, its own dark pool, and Deutsche Börse has announced they will be trading and clearing main European stocks linked with other derivatives in order to optimize costs.

Some of the new MTFs have also claimed they will expand into other asset classes in order to diversify risk and increase their margins. They will also allow their clients to net their margins when trading on several venues.

Additionally, Turquoise's TQ Channel initiative, which will allow dark orders to reach other dark pools, will probably start a disintermediation beyond what is already possible using Chi-X and Turquoise to connect not only brokers but the byside as well.

With certainty I can say that MiFID has introduced changes that are and will continue to be structural in nature. The traditional model of byside connected to sellside, connected to the main markets, whose objective it is to find liquidity for its clients, is beginning to be part of the last century.

On the other hand, we also see full service brokers trying to internalize more client order flow (against other clients or against prop books) rather than showing their orders outside.

TAG'S VISION

In the first scenario we see the natural results of previous events still occurring. Pre-MiFID the European players could be divided into three 'leagues' according to annual trading volume (Premier: LSE, Deutsche Börse, Euronext; Second: OMX, Borsa Italiana, BME, SWX; and Others: 20 other venues including Plus Markets, SWX Europe and Chi-X).

Looking at the current situation, there are some players that have responded to the competitive pressures of the newly fragmented landscape by merging, such as Borsa Italiana with the LSE and OMX with NASDAQ, whereas some main players, like BME or Deutsche Börse, have yet to show how they will respond in the longer term. We will continue to see initiatives on non-displayed orders, with TQ Channel announcing interfacing their non-displayed

book with their members' books, for example. As dark liquidity is still very fragmented – atomized is perhaps the word – initiatives to link the dark side could make several small holes into one big one.

Competitive pricing, as recently demonstrated, is not the answer. Offering an aggressive discount will temporarily attract orders, but in the long run, since this represents a cost, if volumes are not there the bottom line will turn red.

A second scenario would be one where the economy and volumes recover quickly. In this case, fragmentation might continue, in which case we would certainly see more newcomers, particularly from non-European main markets and some bulge bracket brokers in the dark arena.

The third scenario is one in which the economy recovers slowly and/or volumes stay the same. In this case, volumes will not recover, or not to the September/October 2008 levels, and consequently there will be a thinning out of venues in the market place and we will see a period of consolidation. The possible outcomes would be that some will merge - the platforms with similar order flow, client behaviour or market model; some will disappear - those venues not in the position to adapt; and some will be bought by bigger or more financially stable ones.

The drivers for consolidation can be either order flow or technology, with the main incentives determined by the amount of volume attracted and the market model.

THE US COMPARISON

We can't look at what might happen in Europe without looking at what has already happened in the US. The initial situation may not have been the same, but we can still draw valid predictions from the US experience. After a first phase of creativity, some ECNs merged or have been buoyed by exchanges, and in the last three years we have seen ATS and dark pool newcomers emerge. BATS Ignition emerged from a group of investors, mainly based in Kansas, who wanted to continue trading on a platform that best suited their special needs for speed and cost.

In conclusion, whether it is fragmentation or consolidation that occurs, the goal is to keep your bottom line in the black. Without that, your "gaming" will be over. ●