Preparing for impact: Reg NMS and MiFID

Two far-reaching regulations will shift the amount of order flow matched in dark pools, says Harry Gozlan, CEO at SmartTrade

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It is well-known that advanced trading technologies are making the markets far more efficient than ever before.

As electronic trading penetrates deeper into markets outside the United States, a proliferation of tools is emerging that are more advanced and more adept at supporting decision-making, routing and trade execution.

Realising the need for greater speed and efficiency, traders now use direct market access (DMA), algorithmic trading, transaction-cost analysis, dark pools and crossing networks to form the fabric of a more efficient, automated global marketplace.

Meanwhile, advanced electronic trading has brought with it challenges as brokers now handle trade volumes greater than ever imagined.

And yet as spreads narrow and commissions shrink to basis points, pennies and minute fractions, how does the broker/dealer expect to process the massive trading volume it needs to maintain profitability?

The answer is liquidity management.

According to an industry research note released in mid-December 2006 by TABB Group, *Liquidity Management: Pushing Automated Trading Beyond Agency Brokerage*, firms are automating their trading process, but only now beginning to develop a comprehensive strategy to manage liquidity.

Although the order-management system (OMS) and execution-management system (EMS) are important components in the electronic trading process, they still do not address the way brokers interact with order flow, how sell-side traders decide to leverage capital or how firms develop consistent valuation and trading strategies across non-exchange-traded products. This creates the need for liquidity management.

TABB Group defines liquidity management as the methodology surrounding how firms automate their trading desk, including the rules around valuation and pricing liquidity, the handling of customer order-flow, the matching of internal liquidity and the automated rules and methodologies around provision of capital for internal market making and proprietary trading.

Unfortunately, many of the electronic tools available today lack the ability to help manage liquidity in a fragmented order-flow environment.

This sets the stage for competition between those who can provide the most reliable liquidity and those who cannot.

Neither the order management system (OMS) nor the execution management system (EMS) covers all of the facilities that are truly needed when a firm attempts to automate or streamline the complete suite of trading services. The liquidity-management system, however, is able to provide rules around valuation and pricing of liquidity, handle customer order-flow proficiently and use automated rules and methodologies around the provision of capital for internal market-making and proprietary trading.

"The goal of liquidity management is to automatically manage order flow more efficiently and profitably with limited human interaction," explains Matt Simon, TABB Group research analyst who co-authored the report with Larry Tabb, founder and CEO.

"This means putting tools in the hands of customers to trade themselves, automating the order flow that can be automated, making the most sound automated trading decisions and leaving the difficult trades and risky trades to the most talented traders to analyse and execute." This becomes more challenging as brokers' profit margins on trading declines, adds TABB's Matt Simon.

"As cost pressures increase, they're looking not only to reduce fees, including execution fees wherever possible, but leverage the value of their order flow through liquidity internalisation and the use of internal crossing networks or dark pools."

Looking forward, firms will make large-scale technology investments into achieving higher returns.

Firms will place bets on systems or innovative ideas that either seek out profitable opportunities, or find a way to compete better.

In either case, liquidity management will help firms aiming to streamline their execution process and further expand trading capabilities into additional asset classes and geographies.

Nearly all top-tier brokers are beginning to internalise equity liquidity, providing additional trading opportunities and enabling greater cross-company synergies," Tabb writes.

He adds, "however, as more order flow is internalised, the need for more advanced electronic systems to manage this flow becomes more critical."

He goes on to point out: "It is essential to upgrade order-routing and improve management of order flow and liquidity in a trading paradigm that today is more complex than most current trading systems were built to handle."

Once firms create the requisite, integrated, enterprise-wide reference data infrastructure to implement an LMS program, the LMS determines how the orders will reach the firm, for example, FIX, DMA, Request for Quote systems, how orders move through the firm, how they are valued, risk-benchmarked and eventually priced, hedged and finally whether they will be executed.

A LENGTHENING SHADOW

While dark pools are currently used for equities, TABB Group sees that as liquidity-management solutions expand and as order flow, valuation and pricing information become centralised, they will become more multi-asset, multi-product and multi-geography.

They also expect that equity internalisation rates will shift by 2011.

"The amount of flow matched in dark books will increase as Reg NMS and the European Union's Markets in Financial Instruments Directive (MiFID) make it more challenging and risky to execute equities using more traditional internalisation techniques," TABB Group says.

While many firms have considered taking a methodological view of their trading process and procedures for managing the provision of capital, few have a comprehensive strategy.

"We believe they will need this as customers become more sophisticated and trading technologies make markets more efficient," concludes TABB.

"However, we believe that in three to five years we will see firms move from point-based solutions to more workflow-based solutions that will attempt to be more metrics-driven and more quantitative," TABB adds.

Addressing associated regulatory issues, TABB Group projects that over the next five years, equity internalisation rates will shift with the amount of flow matched in dark books increasing.

This will be caused by Reg NMS in the United States and the Markets in Financial Instruments Directive (MiFID) in the European Union making it more challenging and risky to execute equities using more traditional internalisation techniques, such as block trading and capital commitment.

According to Matt Simon: "This will force more brokers to develop dark pools and centralise their matching and quoting facilities and implement liquidity management solutions to better automate, quote and streamline their internalisation/dark-pool execution facilities."

The research note is available online currently through Smart Trade Technologies, an industry leader specialising in liquidity-management systems that enable investment banks, brokers and exchanges to streamline their execution process across multiple-asset classes.

The new report "reinforces what we have long believed – that liquidity management would be the next phase of electronic trading, once customer flow and order-flow tools were widely adopted."

He adds that TABB Group also believes that as trading strategies grow ever more complex, "execution paths and order-routing for products that firms want to automate within an asset class, such as foreign exchange, equity swaps or sovereign debt, will need to be centralised.

Agreeing with the report's findings, he says, "as more advanced firms analyse the impact of one product against another and they begin to trade the capital structure or the global macro interest rate environment, it will be a necessity to view the interplay among currencies, interest rates, credit ratings, credit default pricing, corporate debt, sovereign debt, equities and their derivatives.

To read the full report from which this article is taken, please visit the website www.smart-trade-net.