THE SEVENTH WAVE...WHAT NEXT IN ELECTRONIC TRADING INNOVATION?

Mike Powell, CEO, Rapid Addition

According to surfing folklore, the seventh wave is the largest of the set. This is perhaps a fitting metaphor for what's about to happen in electronic trading. Recapping on the last three decades, we've certainly come a long way, and whether or not you agree with my preceding six waves, they are certainly significant milestones.

FIX was first formally introduced in 1994 as a means of avoiding transcription errors. This quickly evolved into two-way flow, enabling institutional buy-side to send care orders. The sanctioning of ECNs in 1998 and subsequent US market decimalization in 2001 accelerated the use of algos, with their adoption becoming widespread as liquidity fragmented further following RegNMS and MiFID I. This ignited the latency arms race, spurring the rise of HFT and DMA. Post Global Credit Crisis regulation focused on reducing risk and improving execution quality, leaving brokers to try and differentiate increasingly similar services through the use of Algo Wheels and TCA tools. With MiFID II demanding even broader application of best-ex rules, one could argue that the 6th wave is the increasing electronification across all asset classes.

the seven waves
of Innovation in Electronic Trading

1. 1994 FIX formally launched with v2.7, enabling institutional care orders
2. 1998 sanctioning of ECNs & US 2001 decimalisation grows algo use
3. 2007 RegNMS & MiFID 1 liquidity fragmentation accelerates algo use
4. Latency arms race and rise of HFT, DMA, and sponsored access
5. Post Credit Crisis regulation - prop desk spin-out/rise of hedge funds
6. MiFID II best-ex rules drive electronification across all asset classes
7. Greater end client empowerment in electronic trading?

If every action causes a reaction, then undoubtedly these innovations have had a causal effect on regulation, market structure and the economics of trading. The high costs of participating in increasingly fragmented and regulated markets have combined with real price compression on commissions. Commissions pre-electronification were 20bps and are now less than 1bps in most large liquid stocks. This is compounded by large-scale players leveraging technology to undercut competition to gain share, with the unhealthy consequence being the emergence of powerhouse brokers who dominate many markets. To a certain extent, the availability of improved 'off the shelf' technology and white-label business models for algos and liquidity access has lowered some of the costs of entering and maintaining presence in a given market. While this might help in the short-term, it also means that firms effectively offer very similar services and struggle to differentiate themselves. With price one of the few options left for creating competitive advantage, margins will only suffer further.

The 'differentiation dilemma' is perhaps an opportunity for the 7th wave – a step-change to empower the end client. Despite advances in electronic trading, aspects remain highly inefficient. Client onboarding can take weeks or even months, straining relationships and delaying profitable order flow. Extending trading relationships beyond care orders, adding asset classes, or deploying and tuning algorithms are all time-consuming, resource intensive activities. Co-ordinating relevant staff at counterparties can be painful and further impact time to market. The opportunity to give clients greater self-determination through intelligent tools, allowing them more control of the trading process, can lead to significant efficiency gains. It also meaningfully differentiates firms from their peers. While it might feel counterintuitive for sell-side firms to take a more hands-off approach, many of their clients will find greater control attractive.

Initially, this could take the form of increased transparency, with clients accessing the same level of real-time monitoring as their broker. Self-service tools for risk limit maintenance, updating settlement instructions, and other tasks would all lead to improved efficiency. This can evolve to self-conformance testing, implementing proprietary routing logic, and tuning or switching between algorithms in response to market events. Achieving execution goals effectively becomes a partnership, building stronger relationships as brokers genuinely empower their clients' strategies. Ultimately, high touch intervention becomes exception management as brokers grow increasingly comfortable with ceding tasks to their clients. This in turn drives further cost efficiencies, attracts new flow, and builds customer loyalty.

The irony in all this is that greater levels of self-empowerment create greater client satisfaction and yet, provided the right infrastructure is in place, leads to lower daily operating costs for the sell side.

FIX can be key to this evolution, however, it needs to be much richer in terms of functionality, better facilitating the types of interactive workflow mentioned above. Messages and applications need to be more closely synched than they are today, requiring less customised adaption of FIX, which generates unnecessary overhead. The FIX Trading Community will also need to collaborate more closely in areas such as AML and KYC with other standards bodies like SWIFT, to accelerate greater automation across the trading life cycle.

Whether or not this really is the 7th Wave remains to be seen but reimagining the next level of interaction between sell-side firms and their clients is long overdue. Over recent years our consumer habits have permanently changed, and the current environment is driving change in our working lives too. Firms who embrace this and are at the vanguard of implementing such capabilities have a unique opportunity to position themselves as innovative, customer centric partners in the battle for order flow.

Reimagining the next level of interaction between sell-side firms and their clients is long overdue. The opportunity to give clients greater self-determination through intelligent tools, allowing them more control of the trading process, can lead to significant efficiency gains, increase customer loyalty, and potentially grow order flow.