

New Liquidity Mechanisms for the Buy-side

a report by

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Liquidity is a term that has different meanings to different people. The three main meanings that are useful in an analysis are the ability to trade with immediacy, in large size and at low cost.

Most investors would like their liquidity provider to provide immediacy in large quantities at low cost. However, the three different objectives clearly conflict. If an investor wants to transact in a market well over normal size and low-cost trading (in particular, low market-impact cost), then immediacy should not be demanded. If immediacy is required in large quantities, a higher price must be paid. The main reason for wanting immediacy is that the trader has information that leads him to believe that the security price is about to change and that he should try to transact before this information is in the market. If, therefore, he uses a broker to feed the transaction out into the market piece by piece, the time delay in completing execution may result in foregone profits.

Essentially, successful trading by the buy-side involves undertaking a search for the other side of the trade. To be successful, this search should not alert everyone to the existence of the large trade. Traditionally, a fund manager would either go to a dealer and demand liquidity (and pay a price for it) or employ a broker to search for the liquidity and to take the time necessary to minimise market impact. The use of a broker has advantages: first, it can be viewed as outsourcing a specialised task; and second, it removes responsibility for the task. However, the price may be high in terms of market impact cost.

Concession by the Buy-side

Up to now, buy-side traders have conceded responsibility for setting market prices and have allowed the sell-side traders and market-makers to perform this function. What has happened in markets is that the buy-side has put out orders and sought a price, while the sell-side has put out prices and sought orders. One reason for the much lower salaries paid to buy-side traders has always been that they do not perform the price discovery process and,

instead, contract out all the 'difficult' tasks associated with finding the other side of a deal.

Logically, the buy-side should try to disintermediate the sell-side and capture for themselves the cost of this activity. Indeed, the demise of the broker has been predicted for many years, but there has always been a symbiotic relationship between the two sides of the industry. Despite the high cost involved, there are still strong incentives to continue using brokers.

Brokers provide research, although this is something that could be provided independently. They provide access to initial public offerings (IPOs) but they restrict that to their 'favoured' clients, i.e. those who provide them with plenty of commission business. They also inform their highest commission clients of their best investment 'tips' prior to informing other clients.

However, if the process of distributing IPOs was made more transparent by becoming a market process and not an allocation process and if investment tips were required by law to be distributed to all clients at the same time, the value of the relationship between large active funds and the broker/dealers would diminish. Equally, in a world in which all markets were anonymous and the buy-side did not know which market-maker was servicing its needs (and the market-maker did not know who its clients were), the link between the two sides would clearly be much weaker. Equally, however, there would be little incentive for the sell-side to offer liquidity or to try to meet clients' needs. The market might, in fact, be worse off for such a development.

One important issue is whether or not there are imminent changes in the markets that are likely to lead to the buy-side becoming less dependent on the sell-side, and the possible consequences. There are two main reasons why things might change. First, technology is facilitating possible change. Second, regulation could seek to make new issue markets and research more transparent, and eliminate the advantage that the large buy-side firms may have in their relationship with the broker/dealers.

The Ideal Market

Different investors have different views on what constitutes liquidity. Presumably, the best market structure would be the one that generated the most liquidity. Of course, from the broker/dealer point of view, that need not be the case. A central electronic market that brings every buy-order and every sell-order in a security to a single point at which they can interact and execute is probably the worst type of market from the point of view of the broker/dealers, since there is little scope for a broker to act on behalf of institutional investors to seek out liquidity.

Any investor can go direct to the market and place their own order. The only problem with such a market is that very large orders, if entered in full, are likely to find that the price moves against them. For this reason, most markets have had an 'upstairs market', where large transactions can be broken up into smaller pieces and 'drip fed' into the market. If that drawback is to be overcome without the use of dealer capital and broker intermediation, then there is a need to find a means by which large orders can be executed in one piece with minimal knowledge of the order leaking out and minimum market impact.

There is a question of where to look for liquidity to allow the execution of a large institutional order.

Traditionally, the buy-side trader looks to the broker/dealer and, having paid them a fee, has little interest in how the transaction is executed. The liquidity principally comes from other institutional investors, not from the broker/dealer. Although most people think in terms of broker/dealers providing liquidity, broker/dealer capital is very restricted so, in practice, the broker/dealer seeks the other side amongst his/her institutional clients or through an interdealer-broker, with the hope that, by offering to conduct business sufficiently away from the mid-price, he/she can encourage institutional investors to provide the other side. If, however, this is all he/she is doing, i.e. using his/her contacts and knowledge of who has what in the investment community, then is it not possible that the trader in the investment house could do the same job for himself/herself in such a way as to save substantially on execution cost and, in particular, on market impact cost? Until now, a basic problem has been that he/she does not know what other institutional investors are doing or want to do since they are his/her competitors.

Institutional Investor Mechanisms

A number of mechanisms have come into existence to try to bypass the traditional broker/dealer. Instinet has been successful operating as an agency broker rather than as a

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broker/dealer. It takes no positions in securities and thus has none of the conflicts of interest that can arise at a broker/dealer. It makes an electronic market available to the buy-side, but one that can be mediated through human brokers.

Another successful mechanism is the POSIT[®] system, operated by the Investment Technology Group, Inc. – an anonymous system into which buy-side traders can place their orders, which will execute at mid-price if a match is possible. There is no price discovery in this system, thus, technically, it is not a market. By not being a market, however, it does not require transparency and there can be no information leakage.

Another system that appeared briefly, only to disappear fairly rapidly, was OptiMark. It was designed to give buy-side traders more control over the market and to allow them to express their desire for liquidity in the form of a demand curve indicating the price they would pay for different order sizes. OptiMark failed and, obviously, it was questioned as to why.

Some possible reasons for its problems were suggested at the Plexus Client Conference in 2000, prior to its collapse:¹

- buy-side traders were unwilling to be price-setters;
- buy-side traders were unwilling to create price/volume profiles;
- there was a problem with the ‘black box’ not giving sufficient information on whether or not any executions had occurred;
- traders felt a need for some human ‘hand-holding’ (as is available from Instinet); and
- there were so few executions that traders felt that the time given up to using the system was not rewarded with sufficient trades.

One conclusion from this section of the Plexus Client Conference was that buy-side traders needed to develop the same ‘feel’ for the market as the sell-side had by working orders into the market. From that interaction they would develop a sense of the price of the underlying stock and the price demanded for liquidity in that stock. Without this information, buy-side traders are clearly adrift in a market unless they simply hand over responsibility to the sell-side, with its inherent conflicts of interest.

The latest ‘solution’ that has been devised to try to provide the buy-side with its own mechanism to overcome the problems of using broker/dealers is Liquidnet[™], launched in the US in April 2001. It has been described as the ‘Napster solution’ – peer-to-peer transacting, anonymously, and without an intermediary. It is an institutional-only e-brokerage system providing a decentralised alternative trading system. It is designed to let the largest money management institutions trade large blocks of equities amongst themselves anonymously with low transaction costs and little market impact cost. The main problem for institutions is that their order size has been increasing as rapidly as the amount of capital committed by the broker/dealers to trade facilitation has been falling.

As large orders (for example, 250,000 shares or more in the US) are broken up to try to push them through the market, information leakage occurs. According to the Plexus Group, while commission might be only US\$0.05 per trade, the cost of market impact through delay and missed trades make the total cost more like US\$0.45.

When an order is entered into Liquidnet[™], the system alerts any other institutional investor member that might be interested in taking the other side, or part of the other side, of the trade. Neither side knows how much liquidity the other party is offering or the name of the potential counterparty, but the system will tell the buyer, for example, how many sellers there are on the other side. The system is also integrated into standard order management systems (unlike OptiMark), which means no additional keystrokes.

On the first day of trading, the average trade size was 51,000 shares with volume of nearly four million shares and, on the second day, average trade size was 110,000 shares. There is clearly some potential for this type of system. In the long run, it does seem likely that we will see the buy-side attempt to disintermediate the sell-side under pressure from their clients for improved investment performance through lower transaction costs.

The author would argue that the present model of using broker/dealers is likely to break down once regulation makes markets more open and transparent. In such an environment, institutional investors are likely to look at other mechanisms to help them achieve their clients’ performance objectives rather than abdicating from an important part of their responsibility by simply outsourcing all their business to brokers/dealers. ■

1. Bob Colgan and Mark Edwards, “Lessons for/from an ECN – OptiMark Revisited”, Plexus Seventh Client Conference (2000), <http://www.plexusgroup.com/forum7.htm>