

Smart Liquidity

STRATEGIES & PERSPECTIVES



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Market Structure Regulation Implications for Competition and Costs

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Setting the Stage

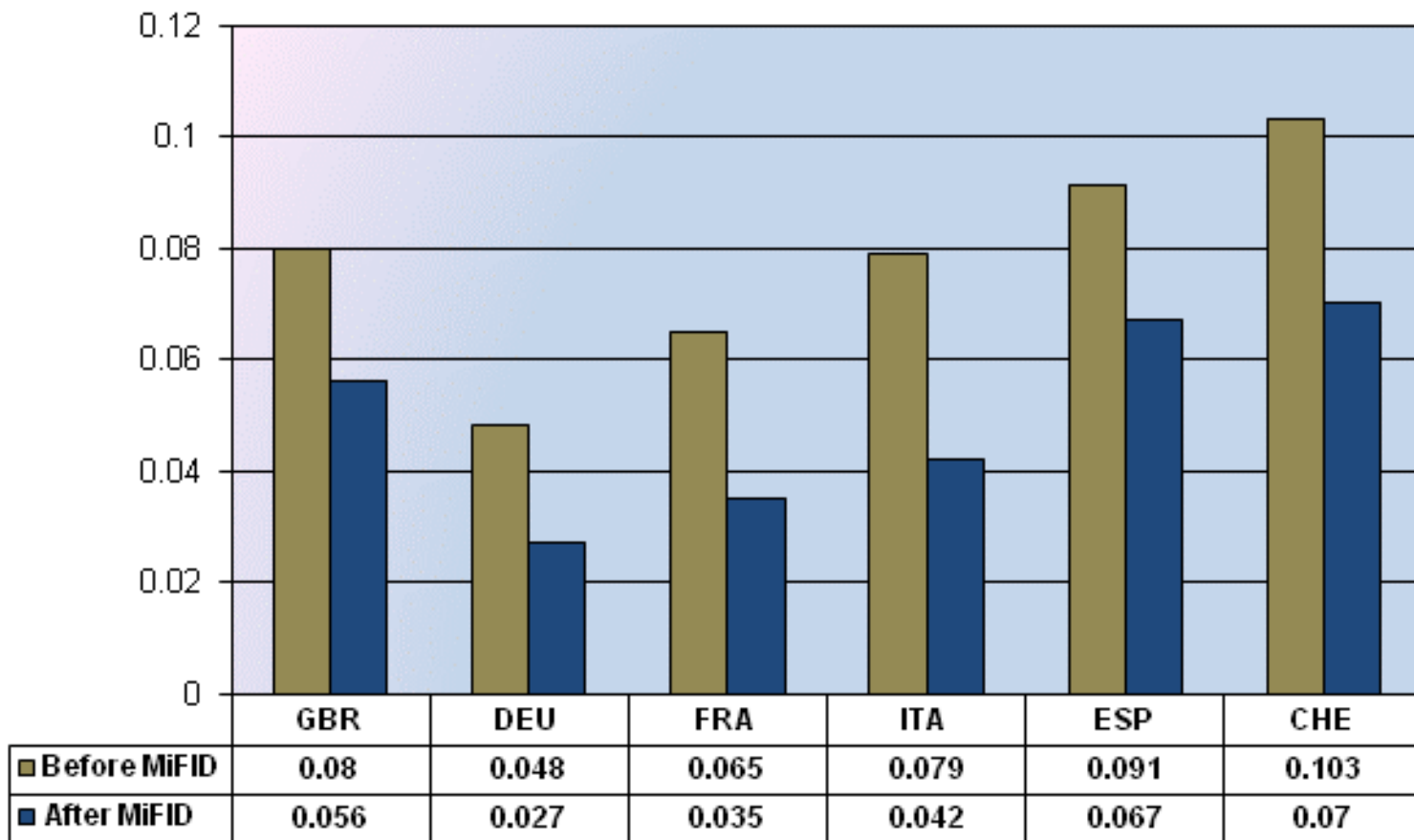
- **As businesses go, stock exchanges are rather curious...liquidity and trading costs will decide who wins**
 - *The Economist, July 2001*
- **This is not a battle between exchanges. The real battle is the exchanges against the broker-dealers**
 - *Craig Donohue, CME, March 2007*
- **The test for MiFID will be whether competition will increase liquidity and efficiency...Wider spreads and an increase in the cost of trading would undermine the whole aim of MiFID**
 - *Clara Furse, June 2007*
- **For the Commission...creating authentic competition between different trading systems was the way to foster innovation and lower transaction costs**
 - *Report to the Minister for the Economy, Industry and Employment, February 2010*
- **We still see anti-competitive pressures from some of the exchanges**
 - *Nick Nielsen, Global Head of Trading, Marshall Wace, April 2011*

The Story Begins in 1969

- **The beginning of market structure regulation**
- **Market structure comprises the rules and institutions which determine competition between trading platforms**
 - *and the means by which they interact with participants in the market*
- **The focus immediately shifted to participants, attempting to fit them into regulatory categories**
- **What was missed?**
 - *Competition is not limited to alternative execution venues*
 - *It focuses on value-added propositions for trade execution services*
- **Back to the participants**
 - Market makers
 - Institutional traders
 - Brokers
 - Venues
 - Buy-side portfolio management
 - Regulators

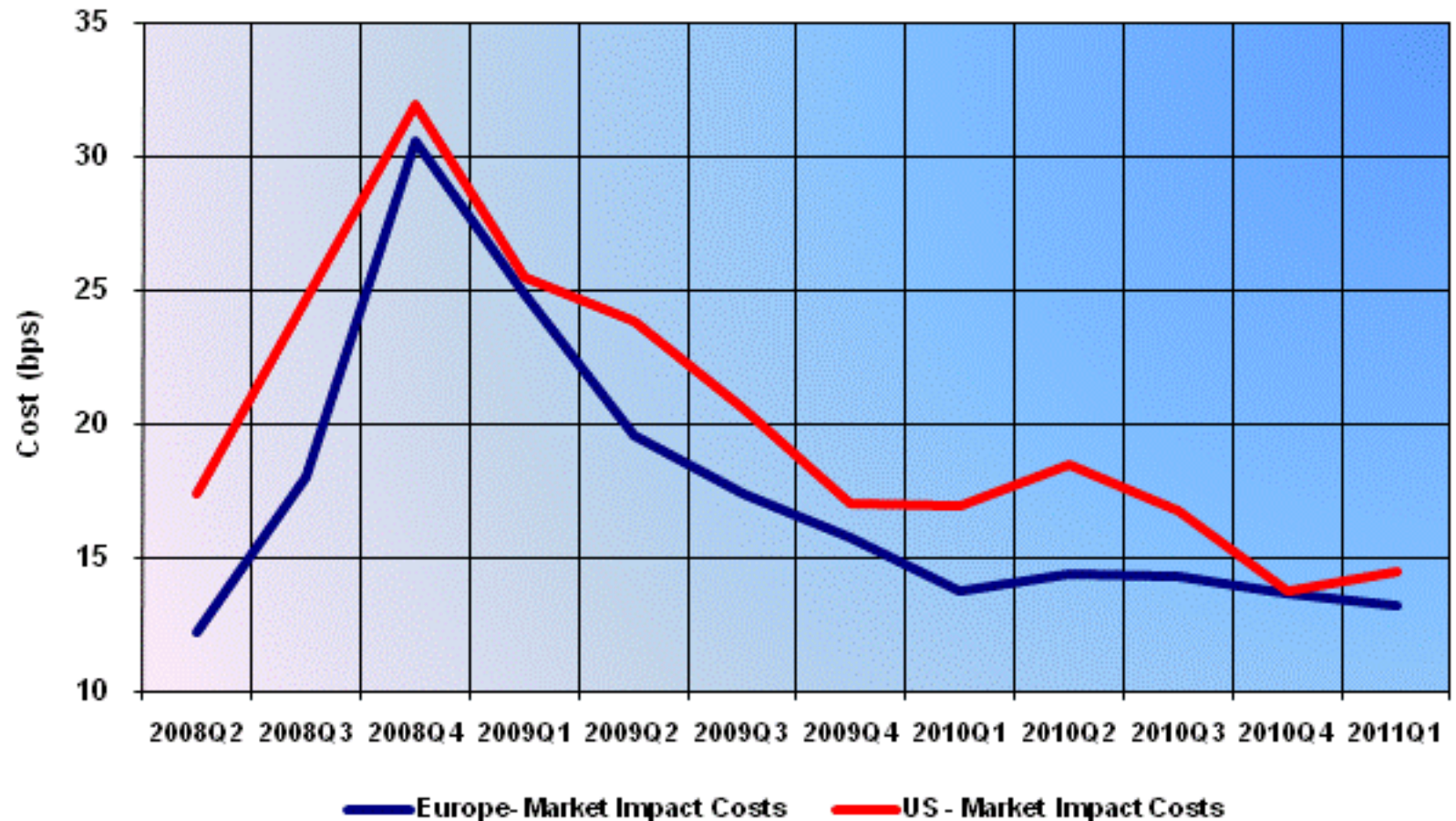
Market Makers: Spread Costs

Volatility-Adjusted Spreads



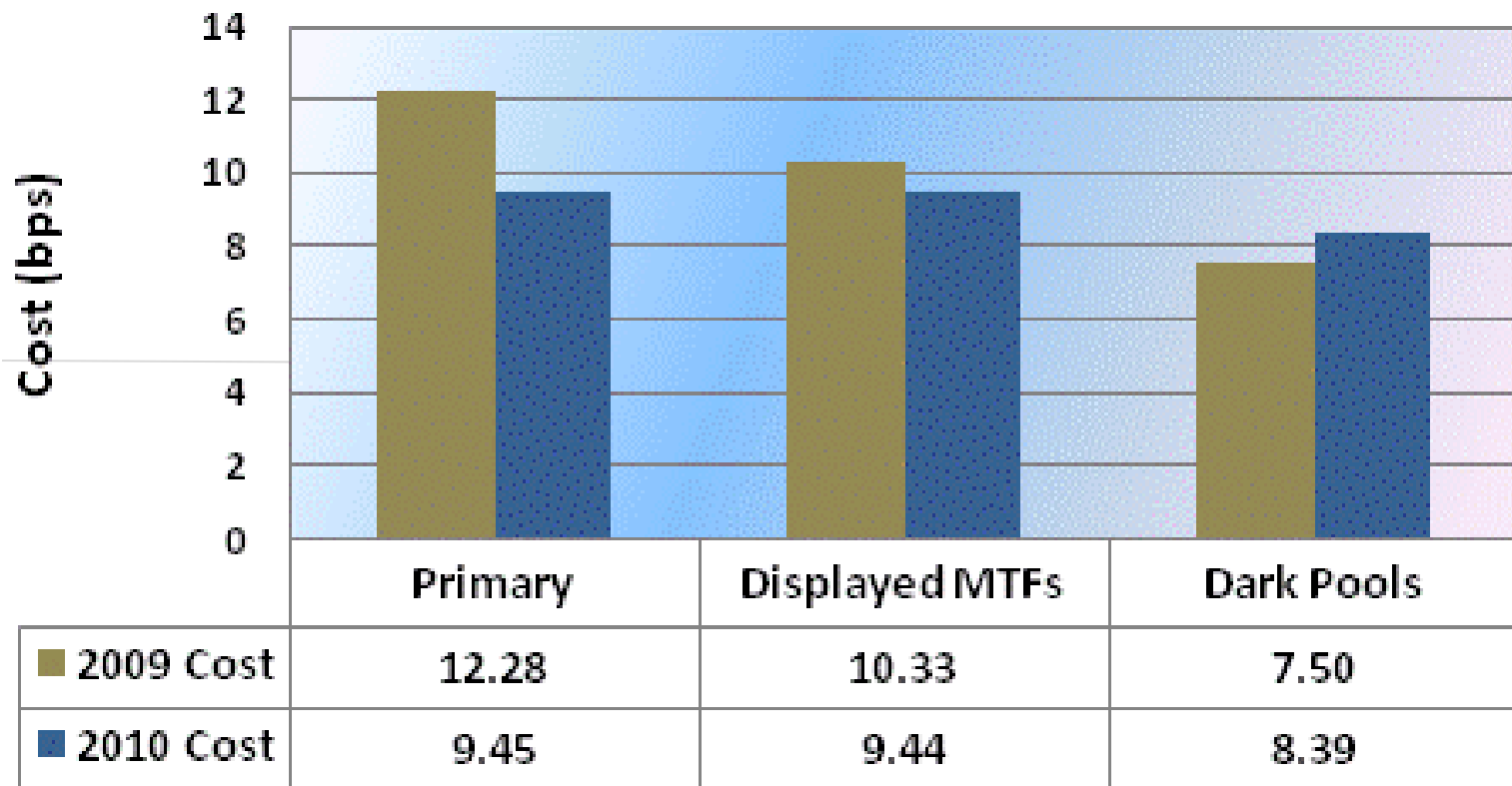
Institutional Trading: Market Impact

Market Impact Costs



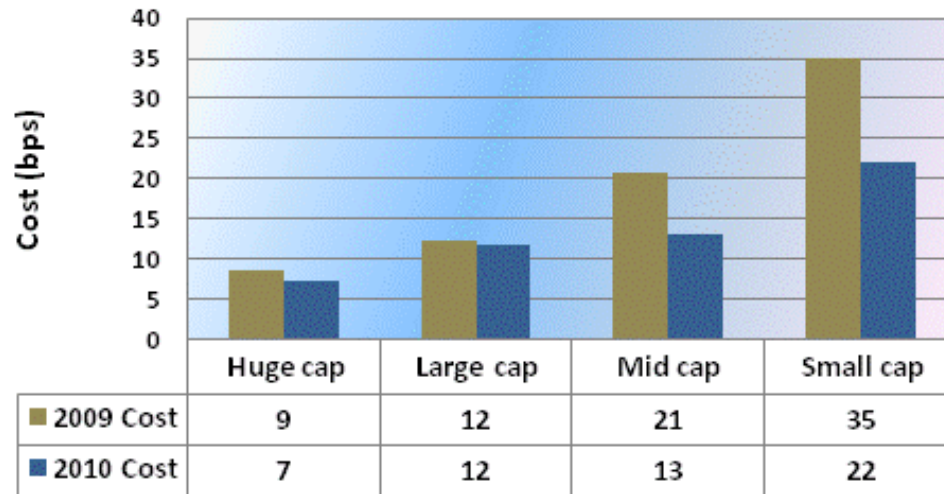
Venues: Execution Costs

Venue Costs

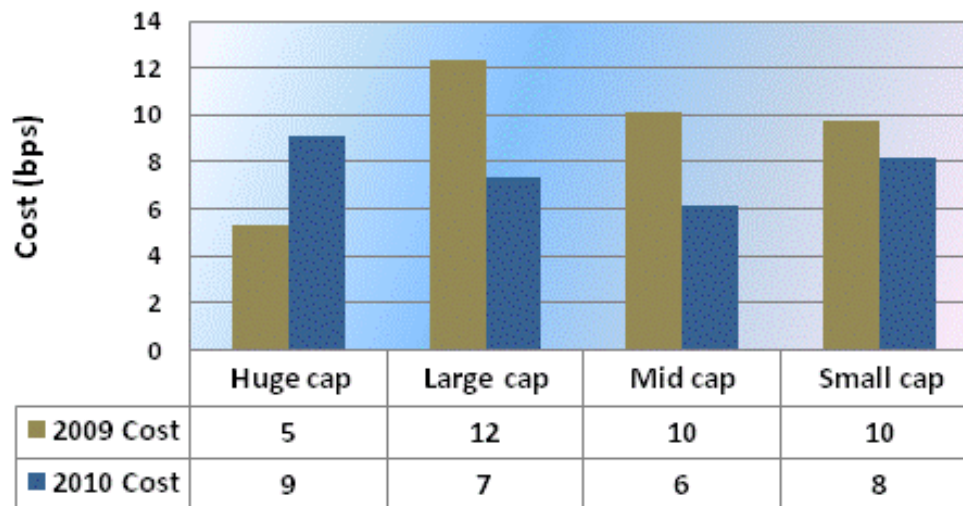


Composition of Costs

Primary Market Costs

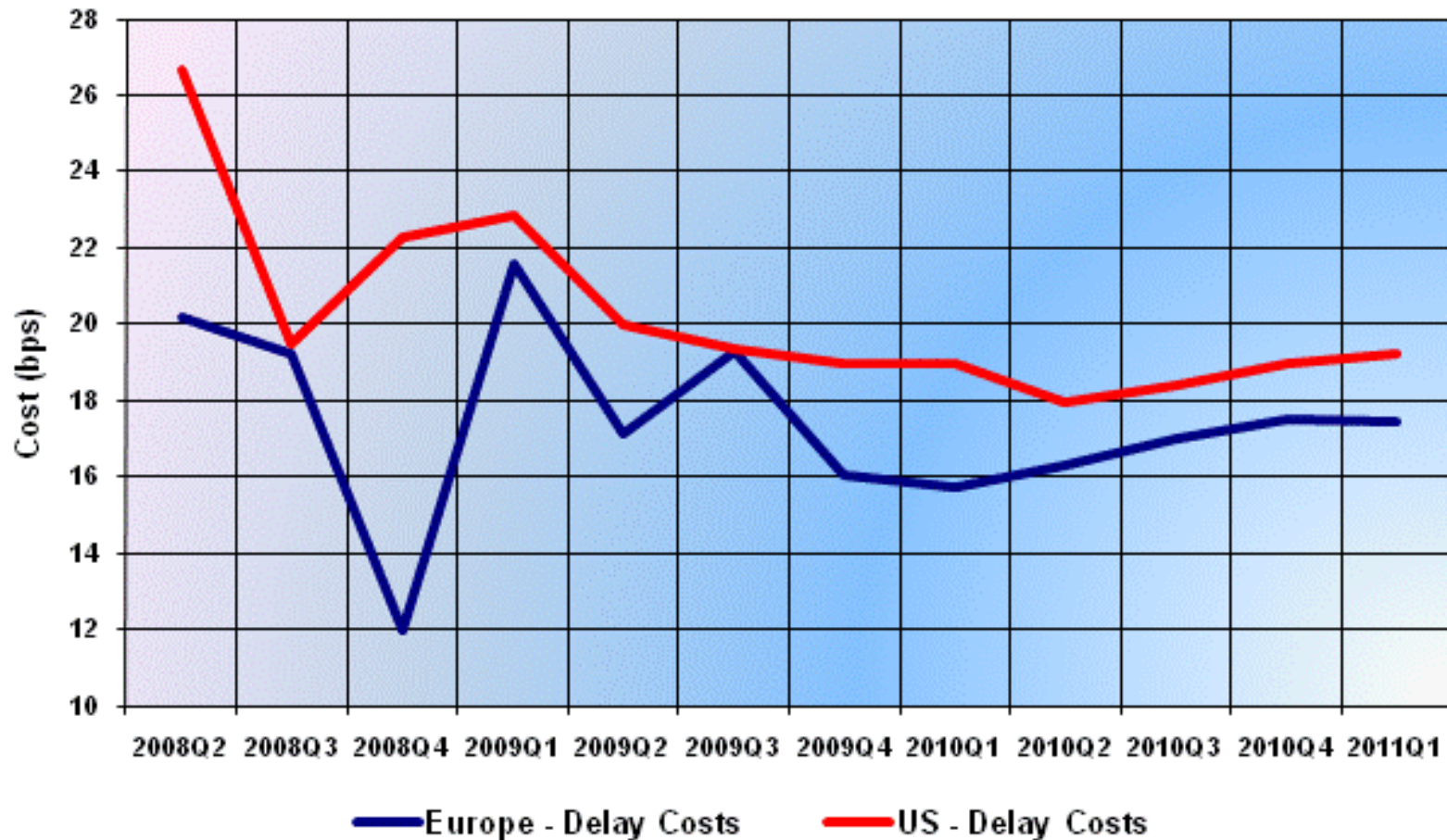


Dark Pools Market Costs



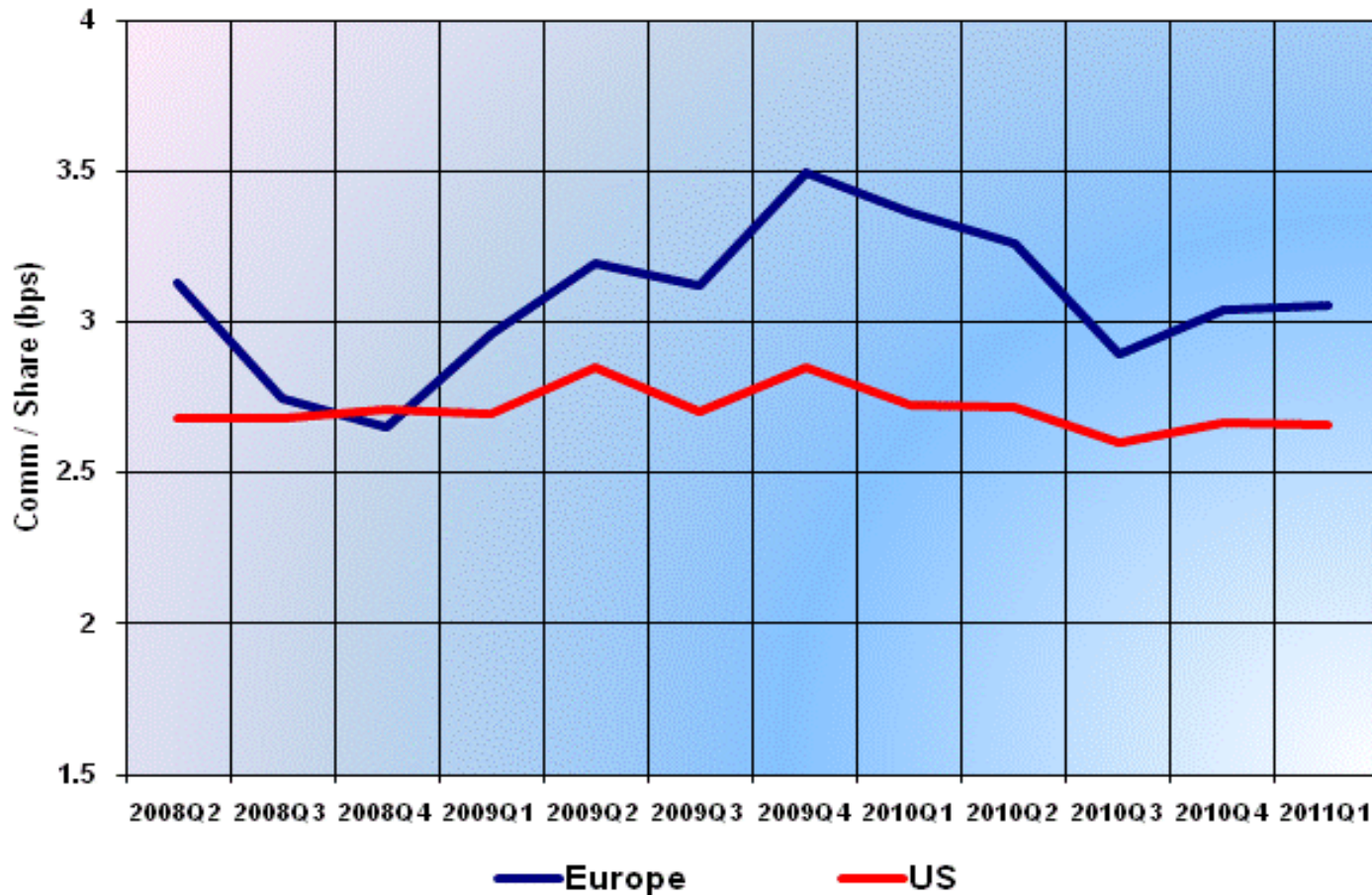
Buy-Side: Delay Costs

Buy-Side Delay Trading Costs

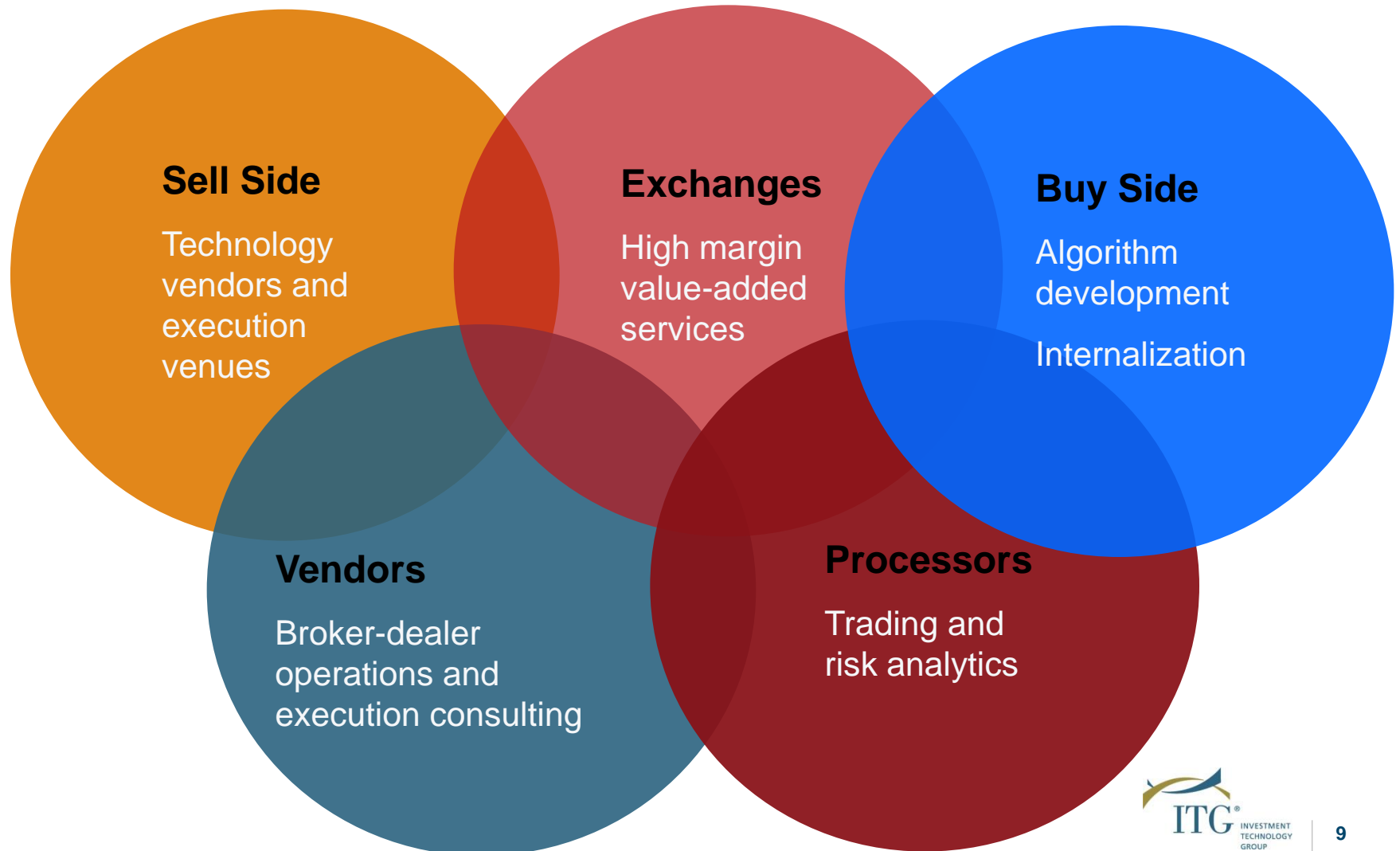


Brokers: Commissions

Commission Costs



Competition and the Loss of Regulatory Language



The Exchange-Broker Divide

- **“Exchanges will now have to find out what exactly their customers want. This ought to be self-evident: a cheap and effective trading system. But, it is not that simple.”** *The Economist, July, 2001*
- **Exchanges as technology companies or financial institutions?**
- **Exchange rebundling versus broker reintermediation**
 - *Creative combinations of financial services elements, leveraging the technology and information capabilities of electronic market structure*
- **Rebundling as a choice, optimal when**
 - *Complementarities are high*
 - *Marginal costs are low*
 - *Unbundled services are commoditized*
 - *Competitive barriers to entry are desirable*

Convergence

Broker-Dealer Reintermediation

- Trade execution
- Execution management
- Trading decision support
- Information services
- Strategies and algorithms
- Capital and liquidity pools
- Managed financial networks
- Technology provider
- Fundamental research
- Global, multi-asset

Exchange Rebundling

- Trade execution
- Workstations/portals
- Trading decision support
- Data provider
- Order types and algorithms
- Liquidity aggregator
- Network businesses
- Technology provider
- Research aggregator
- Global, multi-asset

Last Thoughts

- **Globally, regulators continue to struggle with definitions**
 - *High-frequency trading is another current example*
 - *Difficult to regulate an activity if one cannot define it*
 - *Market structure regulation, as opposed to regulation of individual entities*
- **The financial crisis mitigates the effect of the regulatory attempt to encourage competition**
 - *At one point, 20+ new entrants and a lot of promise*
 - *Downward pressure on volumes destroys nascent MTF efforts due to fixed costs*
 - *Exchanges are taking over the independents*
 - *Others are consolidating*
 - *Smaller commission pools result in fewer brokers, with electronic capabilities, taking volume away from MTFs and channeling liquidity through BCNs*

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