

Buy-side Electronic Trading and Best Execution in Canada

Author: Jackie Chung, CFA

Published August 2005

Price: C\$6000.00

Executive Summary

The institutional equity trading landscape in Canada has long been characterized by thousands of phone calls between buy-side traders and their brokers. The buy-side's reluctance to invest in technology is often cited as a stumbling block that slows the development of electronic trading.

But in the face of mounting pressures from regulators and clients to prove best execution, control costs and reduce errors, Canadian buy-side firms today demand that their trading desks deliver more for less. To survive and thrive in the change, many buy-side traders have turned to technology to increase efficiency and reduce errors. As a result, technology has taken the Canadian investment industry by storm in the last two years. The world of electronic trading is already here. The penetration of technology in institutional equity trading will transform the way Canada's equity market operates, and cause significant changes in the role and skill sets of the buy-side traders.

To start with, buy-side adoption of advanced order management systems (OMSs) has reached a critical mass. Since 2003 the penetration of OMSs in the Canadian buy-side has increased by 240%. Six out of 10 money managers now have an OMS in place. Not only that, 87% of the buy-side trading desks are already connected to electronic trading systems (ETs) that enable them to execute trades electronically at lower trading commissions than through the traditional brokers and to access the exchanges directly. The Canadian buy-side's investment in OMSs and ETs refutes the myth that they do not invest in technology.

Currently many of these newly installed technology tools are not being fully utilized as most buy-side traders are still testing and learning how to use them. The telephone is still used for two-thirds of Canada's equity order flow. Less than 1 in 5 buy-side trading desks use electronic trading systems for 20% or more of their equity trading activities. However, the author forecasts that 2006 will be a turning point for the Canadian institutional equity market. As more money managers order management plans are put in place, and as existing OMSs implement FIX connectivity, the telephone will be replaced by electronic order routing as the dominant method of trade communications. Buy-side traders also plan to direct one-fifth of their equity business to electronic trading systems in 2006.

The rapid adoption of technology in equity trading by the Canadian buy-side is driven by the structure of its equity trading desks. Unlike many of their US peers that have a large team of in-house equity traders, Canadian buy-side firms typically have a small equity trading desk. With just a few traders managing numerous broker relationships, many buy-side equity desks have turned to technology to increase trading and operational efficiency, and to minimize costly manual errors. The transparency of the Canadian equity market also prompts traders to seek ways to maintain anonymity via electronic trading.

Although the technology infrastructure is taking shape and traders are planning to buy and sell more stock via the ETs, the author sees that the path for the Canadian buy-side firms to get to the electronic trading nirvana is still lined with obstacles. Traders have identified several

impediments related to industry practices, the Canadian market structure and internal technology constraints that prevent them from trading more on the ETSs. In particular, it will take some time for algorithmic trading to grow from its infancy to the stage of being widely used in Canada.

Meanwhile, as the trading landscape evolves, the buy-side traders themselves are also ready for change. Many are looking for new ways to add more value in the investment process to stay ahead of the curve. Traders' desire to add more value and enhance investment performance is driving interest in transaction cost analysis (TCA). Nearly 90% of the Canadian buy-side trading desks plan to use transaction cost analysis tools before and after the trade to assist them to measure value and create value. Regulatory pressures for money managers to prove that they have achieved the best price and best execution for the clients is also a driving force behind the buy-side's interest in TCA.

As the world of electronic trading unfolds in Canada, significant changes in the role of the buy-side traders and their skill-sets are projected. Technology will not replace human traders; it simply empowers the traders with additional tools to take more direct control of their trade flow and their future. The expertise, knowledge and experience that a trader commands will still be the key to success in the shifting trading landscape. However, technology will free up traders from manual tasks and place a premium on analytical skill sets. In fact, 60% of the buy-side traders see themselves using more automation and electronic trading technology going forward.

Traders themselves are also becoming more aware of their own accountability and responsibility as they prepare for the change. The future buy-side traders will be adding value beyond trade execution, and be more involved in the investment process.

The "Buy-side Electronic Trading and Best Execution in Canada" Report

This report summarizes the interviews that Jackie Chung, President of Competitive Metrics Inc. conducted with head and senior traders at 30 buy-side firms across Canada. These firms manage more than C\$1 trillion in aggregate assets and include four manager segments. The report covers the Canadian buy-side trading desks' usage trends and volumes for electronic trading, direct market access, algorithmic trading, FIX protocol and transaction cost analysis, as well as their practices and plans for best execution, soft dollars and broker relationships. Buy-side traders' views on how they can add more value and how their role will evolve are also discussed. The report is 48 pages including 37 exhibits. See below for a table of contents.

For more information or to acquire a copy of the report, contact:

Jackie Chung, MBA, CFA
President, Competitive Metrics Inc.
Tel: 416-568-7439 / Email: jchung@competitivemetrics.com

Competitive Metrics Inc.
161 Bay Street, Suite 2600
Toronto, Ontario M5J 2S1
Canada
www.competitivemetrics.com

Buy-side Electronic Trading and Best Execution in Canada

Table of Contents

| | |
|--|----------|
| In This Study | 2 |
| Executive Summary | 3 |
| Table of Contents | 5 |
| List of Figures | 7 |
| Situation Overview | 8 |
| Investment managers face pressures to enhance best execution | 8 |
| Is technology the right solution for Canadian firms? | 8 |
| Interviews with 30 buy-side firms reveal changing realities | 9 |
| Technology is transforming the Canadian buy-side trading desks | 11 |
| Small trading desks using many brokers underscores efficiency needs | 11 |
| Buy-side order management system adoption reaches a critical mass | 12 |
| FIX usage gains momentum as firms adopt OMSs | 12 |
| Electronic trading systems penetrate buy-side equity desks | 13 |
| But most equity order flows are still routed by telephone | 14 |
| OMS and ETS benefits indicate technology is the right solution | 15 |
| How do Canadian firms use electronic trading technology? | 17 |
| Most firms use ETSs to execute a small portion of their equity turnover | 17 |
| Traders are split as to where they stand versus their peers | 17 |
| Trading efficiency and anonymity drive electronic trading | 18 |
| Buy-side traders use ETSs mainly for Direct Market Access | 19 |
| Algorithmic trading is still in its infancy | 20 |
| Which OMSs and ETSs do firms use? | 21 |
| ETS and OMS purchase decision-makers | 23 |
| Buy-side traders face major impediments for electronic trading | 24 |
| Will these impediments compromise the future of electronic trading and best execution in Canada? | 26 |
| Research is still key to get on the 'Approved Brokers' list | 26 |

| | |
|--|-----------|
| But the buy-side/broker relationship is changing | 27 |
| Firms scrutinize soft dollar and adopt best execution policies | 28 |
| More OMSs and more sophisticated OMSs are in store | 30 |
| FIX usage and electronic order routing will soar | 31 |
| Electronic trading systems will see heavier use | 33 |
| Direct Market Access will increase as ETSs and FIX gain traction | 34 |
| Algorithmic Trading won't take off right away | 35 |
| Buy-side traders are ready for change | 36 |
| Traders' desire to add value drives Transaction Cost Analysis | 37 |
| Electronic timestamps turn TCA into a powerful 'real-time' tool | 39 |
| Canadian market structure makes TCA more challenging | 40 |
| Will the role of the buy-side trader evolve with the industry? | 41 |
| Traders become more aware of their accountability | 41 |
| Traders propose three actions to foster electronic trading and best execution | 42 |
| Buy-side traders see their role changing | 43 |
| Conclusion and Future outlook | 44 |
| Study refutes buy-side OMS myth | 44 |
| The world of electronic trading is here | 44 |
| But three challenges still need to be overcome | 44 |
| The buy-side traders have changed...and will continue to change | 45 |
| The human trader will always have a role | 45 |
| Buy-side traders are the real driver for electronic trading and best execution | 46 |
| About | 47 |
| Competitive Metrics Inc. | 47 |
| The Author | 47 |
| Acknowledgement | 48 |