

2007 Canadian Buy-side Equity Trading: Exchange, Upstairs, ATs, What's Next?

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Executive Summary:

A dramatic shift from a dual-marketplace structure to a multiple-marketplace structure in Canada's equity market has created a huge tidal wave in technology use that is going to transform the buy-side traders' trading behaviour and their preferred way to source liquidity in the marketplaces. As a result, the role and responsibility of the buy-side traders will change. A major change also looms in the buy-side/broker relationship.

Canada's equity market has long been characterized by a public marketplace that is often seen as lacking liquidity and the sheer size of its 'upstairs' market. With limited participants and order flow, lots of transactions are negotiated in large blocks 'upstairs' over the phone, away from the public electronic marketplace. Although the vast majority of buy-side trading desks were already connected to electronic trading systems two years ago, few used them actively. But this is going to change. Canada now has 5 Alternative Trading Systems (ATs) and more to be launched soon. The sudden proliferation of marketplaces in the last two years acts a catalyst for electronic trading to take off in 2008. With 5 or 6 marketplaces to monitor, buy-side traders now turn to technology in droves to increase efficiency. As trading moves 'downstairs' to the electronic marketplaces, the resulting surge in order flow draws even more buy-side traders into the electronic trading game. But it has also changed the nature of liquidity in Canada; the traditional block market dwindles. Buy-side traders now have no choice but to find liquidity wherever it is, driving the alternative marketplaces to go mainstream in 2008.

Change is already afoot in the buy-side trading behaviour. Electronic trading is no longer concentrated in the hands of a few major firms and only going to the TSX. Now 1 in 4 buy-side trading desks execute 20% or more of their equity trades electronically. A significant number of buy-side trading desks now send some of their equity trades to these new pools of liquidity. Although the telephone is still used for 52% of the equity transactions, Competitive Metrics forecasts that 2008 will be a key turning point for the Canadian institutional equity market. The telephone will be replaced by electronic order routing as the dominant way of trade communications as order management systems prevail on the buy-side. Buy-side traders also plan to conduct one-quarter of their equity trading electronically. Algorithmic trading will also come out of its infancy. More important, 9 out of 10 buy-side trading desks plan to execute some of their equity trades on the alternative marketplaces. Major changes are also projected in the way block trading will be conducted.

Meanwhile, a dramatic change in the buy-side traders' preferred way to source liquidity is happening as they use technology to take more direct control of their order flow and access the marketplaces directly. The buy-side traders' dependence on their sell-side counterparts is tumbling. Substantially more buy-side traders now prefer to access the marketplaces themselves than those who prefer to fold the trades to their brokers. Buy-side traders have also prioritized a list of 'must haves' that they want for their main desktops to help them find liquidity in different marketplaces. A large number of buy-side traders have also indicated that they have preference for certain marketplace features.

The path for the alternative marketplaces to go mainstream may still be lined with obstacles. Traders have identified several impediments that hold them back from trading more electronically and sending more trades to these non-traditional venues. In particular, on-exchange or off-exchange, buy-side traders are split on their outlook. But Competitive Metrics sees that these obstacles will ultimately fall away as alternative marketplaces as a group go mainstream in 2008. Whether or not an individual marketplace will survive and thrive depends on how well it meets the basic goal of a marketplace to provide enough liquidity to get the trade done at the price, size and time the trader wants.

There are signs that a major change is looming in the buy-side/broker relationship as technology reduces the buy-side's dependence on the sell-side. Buy-side firms in Canada now streamline their broker relationships in droves and concentrate their commissions on a few main ones. Buy-side traders' reaction to the broker 'Alpha' ATS also tells us that what the buy-side wants from the sell-side is changing.

Meanwhile, a major shift in the buy-side attitude towards technology has occurred. The buy-side traders are embracing the change as the trading landscape evolves. 63% of the buy-side traders, no matter what experience they have, now see leveraging new trading technology as their number one way to add value. Buy-side traders' active use of technology and the changing environment are bound to cause their role and responsibility to expand beyond trade execution into more active involvement in the investment process. The trading landscape has changed and will continue to change. So will the buy-side traders. Technology will not replace the human traders. The human traders' expertise, knowledge and experience will always be the keys to success no matter how the trading landscape evolves.

The "2007 Canadian Buy-side Equity Trading: Exchange, Upstairs, ATs, What's Next?" Report:

This report summarizes the interviews that Competitive Metrics' Jackie Chung conducted with head and senior traders at 28 buy-side firms across Canada. These firms manage C\$1.2 trillion in aggregate assets and include five manager segments. The study centers on how the buy-side traders adapt to a new trading landscape of electronic trading and rapid proliferation of marketplaces. The report provides comprehensive coverage of the Canadian buy-side trading desks' usage trends and volumes for direct market access, algorithmic trading, block trading, basket trading, derivatives, FIX, OMSs/EMSs and transaction cost analysis. The report also examines buy-side traders' usage and plans for the alternative marketplaces and their preferred way to source liquidity in multiple trading venues. Buy-side traders' views on how they can add more value and the changing buy-side/broker relationship are also discussed. The report is 67 pages and includes 50 exhibits.

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

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