



MARKET PERSPECTIVE

Smart Order Routing - Meeting future requirements

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As post-MiFID competition heats up between new and old execution venues, sell-side firms face a challenge in devising a smart order routing (SOR) capability that can keep up with the changes to the market. Ulf Lillieroth, product manager, SunGard Front Arena, explains why sell-side firms must adopt a SOR strategy that combines speed and flexibility.

It is two years since the launch of the Markets in Financial Instruments Directive (MiFID) and Europe's equity markets have undergone some major changes. In keeping with the directive's main objective, the natural order where there is one dominant exchange for every domestic market has been disturbed by a wave of new alternative execution venues – from multilateral trading facilities such as Chi-X and Turquoise to the dark pools offered by sell-side brokers.

Time has proved that the competition between the new venues and the incumbent exchanges has continued and the functionality offered is becoming more uniform.

All venues have attempted to address low latency, on-wards routing, dark pool functionality and lower cost in some way so as to successfully compete. They know that it will be hard for them all to survive in the future so the race is now on.

For sell-side institutions this means that the landscape and the offered functionality may change very quickly and it is not obvious what their strategy should be. What is certain is that, with all of the number of ways in which the market could change, the sell-side will need a future-proof and effective order routing capability.

Large banks that have traditionally built their trading systems in-house, have exposed themselves to continuous high costs in order to keep up with development. Many smaller banks can probably not afford to manage

complex solutions of their own so often let someone else do the execution for them or use simpler or very standardized strategies.

The mid-size banks that want to compete successfully and add value to the execution process and not just use a service that is also open for the buy-side, have a more challenging situation before them. Banks that believe they just need to buy or use a smart order router with some best execution strategies for the problem to be solved indefinitely, will be deeply disappointed.

The market is continuing to change quickly and it is likely that new functionality and new trading behavior like the use of dark pools will make it necessary to constantly update and change SOR strategies.

Speed and flexibility

For banks it will then be very important to have a highly flexible smart order router that can adapt to the changes in order to be competitive. Speed and flexibility are often

hard to combine but in this case both need to be addressed when building a router. If the router is slow it must use more defensive strategies which consequently will mean losing out on opportunities.

The distance to the different venues from the smart order router is also of importance when choosing what strategies to use. The speed of light becomes a large part of the total latency when accessing venues overseas. In this case being able to adopt a SOR strategy to consider the latency is important when making the best execution decision.

If you are trading on one exchange, crossing your own orders is usually no problem. Many exchange platforms give priority to such orders which makes it easy to keep the liquidity in-house. However, posting orders to several venues is not such a simple undertaking. The smart order router needs to keep track of own orders in all connected markets, withdraw them and cross them internally in order to achieve the same functionality.

Banks that trade in the order flow today also need this functionality otherwise the risk for front-running customer orders would be high.

In the fragmented market the traditional iceberg order is not so easily handled any more. To post them to one market means that the whole volume is no longer exposed to a maximum. The order could be posted to several markets with a hidden size but not all venues support the functionality and you might want to also use dark pools and make it available for internal crossing. Liquid and illiquid instruments also need different handling. It is important that the smart order router can be tailored to optimize the banks' ability to handle large volume orders with a minimum of market impact and still be able to execute the volume without delay.

For a long time, the largest banks have been able to cross order flows internally before orders have been sent to execution venues. The new trading landscape makes this functionality more interesting for mid-size banks as well. With the use of SOR tools, the

first step to achieve this is already taken. The internal crossing facility could be regarded as just another dark pool and easily integrated into the strategies. This would be an important step to avoid giving away more liquidity than under the previous scenario.

The smart order router is starting to be regarded as a commodity in an order management system. It is no longer just a service that you buy for part of the order flow but is an integrated part of any trading system and should be the centre of all trading decisions. By abdicating some control of execution to a smart order router, the sell-side is starting to resemble the buy-side in that it no longer controls all trading decisions.

However the situation is not black or white and there are, of course, some grey areas where sell-side firms can retain some influence by applying parameters to the execution process. Ultimately the strategy will depend on the sell-side bank's philosophy – some will never willingly give up their control over execution while other firms accept that execution is not their core competency and feel that they can add value to the buy-side in other ways.

New market venue considerations

Consolidated systems:

For the larger firms dealing with institutional orders, there is a need for liquidity discovery and aggregation, connectivity, workflow and smart order routing to be provided through one consolidated system.

The only way to gain full control is to have the smart order router connected to the order management system. Of course this can be done by using middleware to integrate a smart order router and an order management system from two different vendors but by installing a system that has this functionality built-in there are sizeable benefits.

Not only will firms save on the integration work but they will have much better control. The SOR functionality can be combined with the order flow, providing much better granularity into how the order flow is designed. Links can

then be made with a firm's own proprietary trading activity, creating the possibility of internalization.

It is about looking at the whole lifecycle, from pre-trade to allocation, rather than dealing with processes in isolation and relying on multiple systems.

The pre-trade process has become a far more important aspect in the competition to attract liquidity. As the number of venues expands it will become more difficult to gain a consolidated view of the market's trading activity and to obtain a true picture of liquidity.

By providing clear and transparent information in terms of indications of interest and actual trading activity, this will not only serve to make the marketplace more efficient but can also be an effective marketing tool as a means of broadcasting the evidence of a firm's market activity.

Sell-side firms are also able to make more timely decisions regarding their execution strategy and whether to pursue internalization. The incentive for internalization used to be the size of the spreads but these spreads are decreasing. The main incentive is now liquidity. The ability to post orders on your own internal market and to offer improved prices in comparison to the rest of the market

will be an increasingly effective way to attract buy-side customers.

Executing program orders involving large volumes also becomes a more manageable task when the smart order routers are combined with the order management systems. This link allows the smart order router to be more intelligent in its search for liquidity and in the algorithmic trading functionality used to help execute the order.

Program trading used to be a very labour-intensive process with several traders used for every program but now one trader can manage many different programs. The turnaround time from receiving a customer's order to the point of execution also becomes vastly reduced when the smart order router and order management system are combined, allowing for multiple orders to be acted on simultaneously.

As credit conditions continue to contract and technology budgets are tight, firms will only invest in solutions that can promise to reduce cost and also increase revenue. By using a trading platform that seamlessly combines smart order routing with order management, these twin virtues can be achieved.

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