
Bringing Back the Block

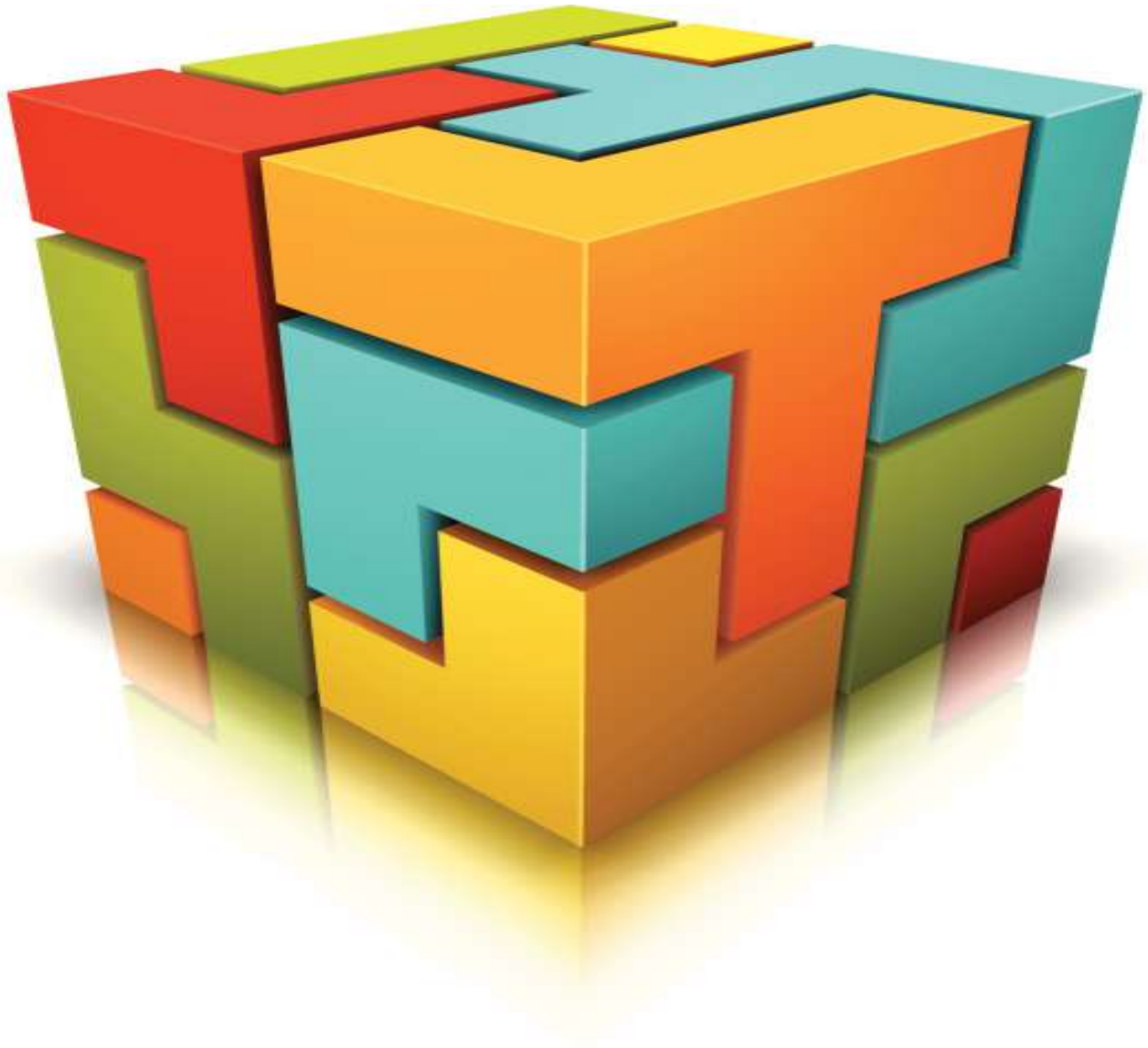


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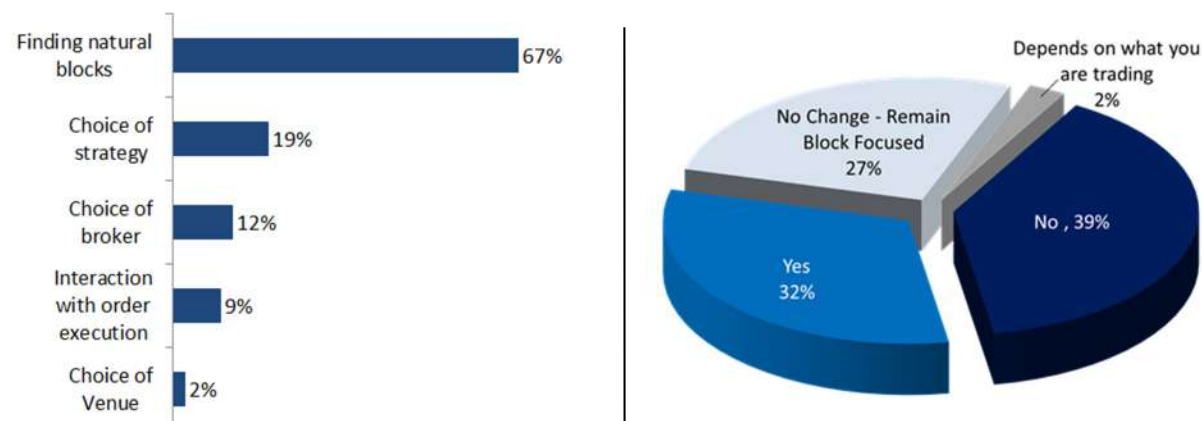
Introduction

The utopia of equity trading – the natural block – is becoming the essential modus operandi for many. In terms of execution, 67% of buy-side participants now place more importance on finding natural blocks than choice of venue, broker or strategy (see Exhibit 1). Yet only a third are actively moving from schedule-based trading back to blocks (see Exhibit 2). While many may claim to want to trade blocks, block trading remains elusive, more often a problem of perception versus reality.

Exhibits 1 and 2

Most Important Factor in Terms of Execution

Move Away from Scheduled Based Trading Back to Blocks?



Source: TABB Group

The main objective of MiFID II is to increase transparency. Changes to broker crossing networks and the introduction of dark trading volume caps will significantly impact the ability of institutional investors to execute order flow via the dark. Although European regulators have indicated their intention to protect institution-sized business by excluding large-in-size orders from volume caps, this alone is not enough to guarantee an increase in block activity.

Liquidity may pool but it still needs to move, and the ability to facilitate trades in the post-MiFID II world is the elephant in the room. If MiFID II regulation prevents brokers from matching riskless principal trades going forward, block liquidity risks becoming intransigent and the negotiation of trades potentially harder to achieve.

The continued overall decline in the use of risk capital means buy side firms will now have to improve information flows rather than rely on their broker to deliver natural business. The ability to receive and consume accurate indications of interest (IOIs), as well as measure and monitor the value individual brokers provide occurs at a time when most are highly skeptical of the information they receive. There is also additional pressure with the inclusion of IOIs as possible market manipulation under the European Market Abuse Regulation (MAR).

The market will of course adapt. Technology is already improving information flows to locate natural liquidity and fast-moving sell-side firms have spotted the gap in the market. Dedicated

block desks are springing up at sell-side firms which have firm-wide access to internal books across the floor. To protect client trading intentions being leaked in the usual manner, these block desks are also ring fenced internally.

There is also a change in approach by the buy-side. Asset managers are no longer sitting by passively waiting for information flows. Holding the majority of the assets means the buy-side holds the liquidity, and as such is choosing to become the instigator of blocks. Improved order management system technology and greater automation of processes enables firms to trawl asset managers' current, past and intended portfolios to find potential opportunities to trade.

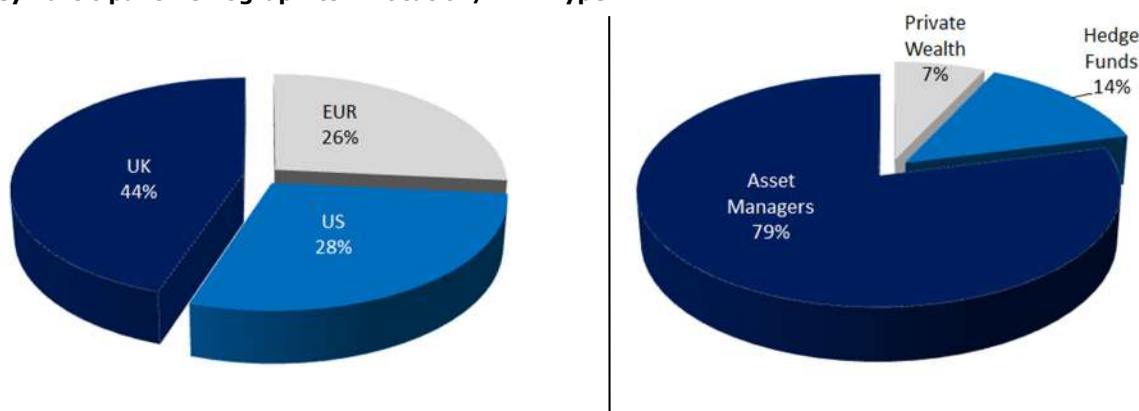
This shift of information flow to the buy-side creates a new dynamic. The question remains whether broking will continue to be mission critical to bringing back the block, or if technology will eventually facilitate full buy-side to buy-side negotiation of blocks. The recent success of block crossing offerings illustrates how venues and brokers are adapting to new opportunities to create block trading. Alongside well established alternative methods of pooling liquidity such as Liquidnet and ITG Posit, new entrants, Luminex, Plato and Turquoise, look set to reshape the traditional buy-side and sell-side relationships still further.

However, ultimately, any increase in block trading will depend on the level of urgency to complete the trade. Trading blocks does not suit all strategies. The growing regulatory importance of a firm's ability to demonstrate best execution – on the buy-side as well as the sell-side – will ensure firms need to optimise all opportunities available to meet regulatory obligations. Where there is significant order imbalance or high market momentum, trading in smaller sizes over the day may deliver better execution. As market volatility increases, buy-side firms will need to capitalise on opportunities as and when they become available. This will require greater information flows, as well as improved accuracy, standardisation of data and deeper analysis to establish when, where and how to trade.

To investigate these challenges, TABB Group spoke with 43 global heads of trading in August 2015 to establish how firms plan to adjust to MiFID II in light of the current market structure, and whether current proposals will succeed in bringing back the block (see Exhibit 3 and 4).

Exhibits 3 and 4

Survey Participant Demographics – Location/Firm Type



Source: TABB Group

Block Benefits

Trading natural blocks is both the utopian trade and the ultimate challenge. The theory is that

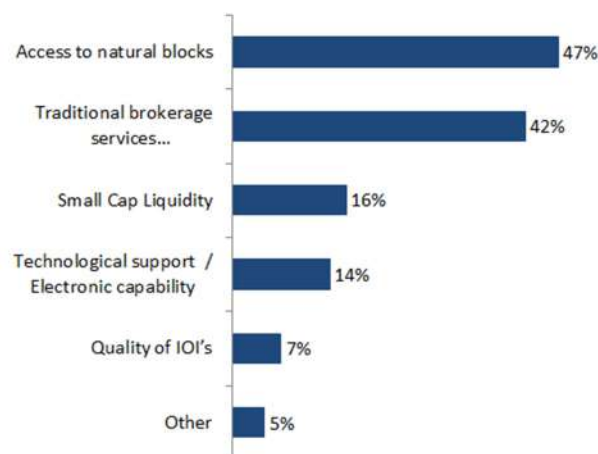
"The appetite for blocks is still there-we just still haven't figured out yet the best way to make blocks happen"

-EU Asset Manager

if more buy-side traders commit to blocks, a greater number of blocks will be executed. Yet the situation continues to frustrate. The ability to find a natural block is now the most sought-after commodity that a sell-side broker can offer (see Exhibit 5).

The combination of fewer asset managers holding a larger share of inventory, often on the same side of the trade, together with banks' reduction in balance sheet, has led to a progressive erosion of trade facilitation. While traditional brokerage services are still highly valued, greater unbundling makes it harder for brokers to differentiate execution offerings in the traditional sense. A global investment bank may have greater flow visibility, full exchange membership and state-of-the-art technology, but without advisory services and the ability to offer capital, true execution capabilities are laid bare.

Exhibit 5
What is Your Number One High Touch Requirement from Brokers Today?



Source: TABB Group

"We haven't seen any dramatic increase in blocks. What we are seeing is larger crosses rather than the small fragmented clips from dark MTFs"

-Large UK Asset Manager

The brokers that the buy-side trusts will maintain the edge. A stronger relationship facilitates open dialogue, which results in greater opportunity to uncover natural order flows and improve execution capabilities. However, paradoxically, once a trader is seeking liquidity, the potential for information leakage creates a level of paranoia, which risks preventing even the most advantageous execution.

While theoretically, crossing at mid will prevent information leakage and reduce market impact, the risk of opening up the full size to even a trusted broker can evaporate in a sea of mistrust. Larger institutional order sizes challenge the likelihood of matching two-way liquidity, and small and mid-cap traders in particular can appear like rabbits in the headlights, trapped in fear of any potential information leakage.

"Due to the size of orders we have, we have to find the other side or we are in the market and will incur impact costs"

-UK Asset Manager

Blocks Away

Executing block trades not only requires finding the other side of the trade, but an element of facilitation in completing the trade without incurring market impact. This has been achieved to date via capital facilitation or the use of dark pools. Both methods now appear challenged.

"The use of capital just continues to go down and down. The decline of late has been most evident in fixed income, but equities is not immune"

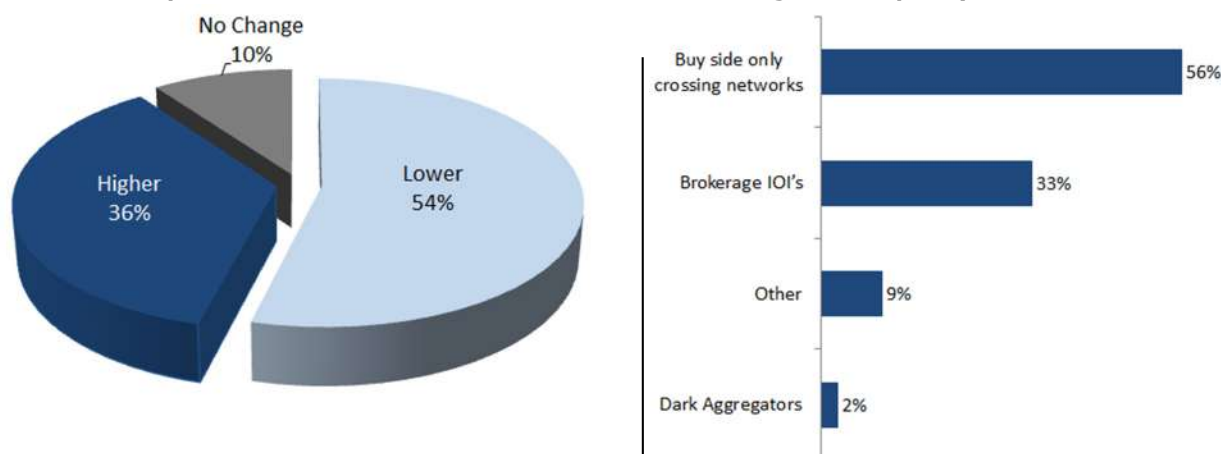
-Large UK Asset Manager

Use of Risk

Over half of the respondents have seen their use of capital commitment decline year-on-year (see Exhibit 6). The increased cost of capital, the creation of a competitor and the risk of influencing the profit/loss ratio at year-end remain strong incentives to find alternatives to risk. However, as risk trading has become more elusive, some brokers are improving their internal organisation of risk books, to ensure their diminishing capital balance sheet is used to its optimum. Technology improvements on central risk desks, and the ability to include a firm's natural hedging such as a derivative unwind, were highlighted by some participants as notable ways to improve facilitation of orders.

Exhibits 6 and 7

Use of Risk Capital 2015 versus 2014 First Port of Call in Sourcing Block Liquidity



Source: TABB Group

Buy-side to Buy-side

Buy-side to buy-side crossing networks remain the first port of call for more than half of the respondents (56%) but the make-up of what constitutes valuable buy-side networks is changing (see Exhibit 7).

"We all know the caps are ridiculous but hopefully it will focus people on sticking to the LIS waiver"

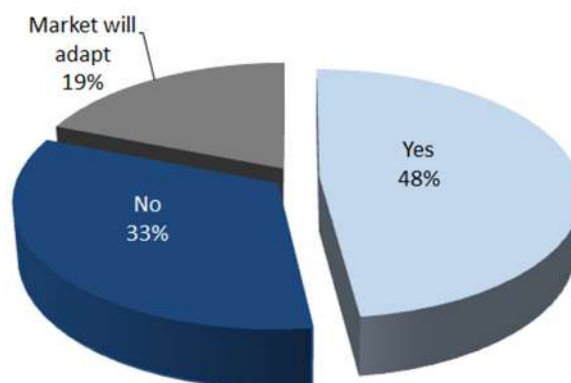
-Large UK Asset Manager

Whereas traditional buy-side to buy-side crossing networks, such as Liquidnet and ITG Posit, remain the first port of call, participants feel challenges will lie ahead for other methods of dark trading such as

aggregators as a result of proposed regulation in MiFID II.

Nearly half of respondents anticipate an increase in large-size liquidity discovery due to regulation (see Exhibit 8) rather than continuing to execute orders piecemeal. Fear of information leakage is already altering buy-side interaction in the dark. The widespread introduction of Fix Protocol Tag 30 (Last Market) and Tag 29 (Last Capacity) has alerted the buy side to the potential dangers of spraying order information across the market. Either firms are choosing to retain full knowledge of the order flow in-house and rely on vendor tools to locate levels of activity, or if going external, information is shared with a decreasing number of trusted parties.

Exhibit 8
Will MIFID II Aid Large Sized Liquidity Discovery?



Source: TABB Group

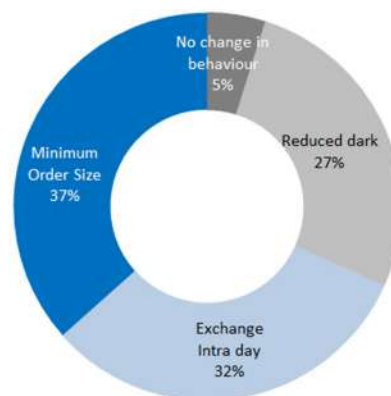
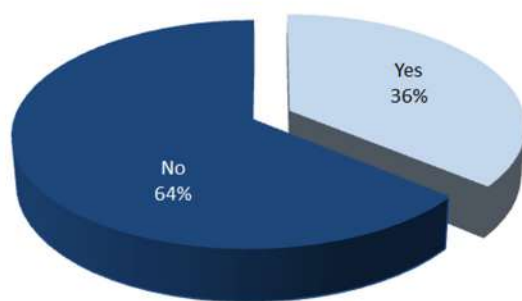
Irrespective of whether information remains internal or goes external, many anticipate market participants being forced to commit to larger order sizes using the large-in-scale waiver. As such, while participants do not anticipate a change in their overall usage of dark trading (see Exhibit 9), they do expect the need to implement a minimum order size to avoid the double volume cap. Only a quarter anticipate reducing their dark trading activity (see Exhibit 10).

"Tools like RANK are particularly useful for mid-caps. Anything smaller than a large cap in IOIs mean the market impact is horrendous"

-Medium-Sized UK Asset Manager

Exhibits 9 and 10

Will the Introduction of a Volume Cap Impact Your Usage of Dark Pools? / How Will You Respond?



Source: TABB Group

New Kids on the Block

"If a venue can fulfil your best execution requirements while protecting you with anti-gaming logic, that's the utopia"

–Large UK Asset Manager

Despite participants' appetite for the ability to trade more blocks, skepticism exists around the introduction of conditional order types by venues designed to target block liquidity (see Exhibit 11). The question is whether this is due to a lack of understanding as to what venues are offering, or if the influx of new order types will lead to greater fragmentation, resulting in market noise rather than genuine

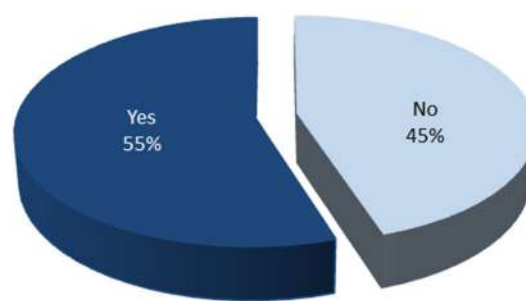
liquidity. Those who approve of the use of IOIs under conditional orders viewed the additional order types as an improvement on traditional IOIs, given they effectively firm up participant orders leading to greater consolidation among certain venues.

Many European venues already struggle to attract sufficient liquidity to survive. Increased regulatory requirements under MiFID II – in terms of compliance, data usage and reporting obligations – add additional costs. To meet these costs, venues are incentivised to create innovative methods to attract further liquidity. Bats Chi-X Europe is the latest European venue to lay down the gauntlet to other venues by introducing continuous auctions later this year, favouring size over speed to market, in an attempt to win back market share – especially from off-exchange dark pools.

Where auctions have been typically held at the start, mid or end of day, Bats' will offer a periodic auctions book offering intraday auctions that operate within a EBBO collar. A new auction would be triggered when an order for a stock is placed, with the auction lasting from between 100 milliseconds to five minutes, depending on demand and market capitalisation of the company. Orders will then be matched on a price, size and time basis in a similar manner to Turquoise Uncross. The idea being that the use of an auction prevents information leakage, although this will depend on whether the whole size of the order can be executed. The London Stock Exchange and the New York Stock Exchange are also planning to introduce their own intraday auctions although they will be offered at set times during the day and inserted into their main order books.

The danger is that as the success of one model spreads, more venues choose to invest in new block initiatives, making it hard for challengers to gain a foothold. Without the requisite minimum liquidity, venues are less like to get on the broker routing list, which prevents any uptick in flow. Ironically, as a result, Europe may end up with only a handful of venues with sufficient liquidity, leading to a reduction in competition among the European exchanges.

Exhibit 11
Will Conditional Orders Increase Market Fragmentation?



Source: TABB Group

"I like conditional order types-it's better than an IOU, you can't see it unless you have something to do, which is not necessarily a bad thing"

–Large UK Asset Manager

"We just don't need any more fancy order types-it's just creating more artificial noise and fragmentation in the market"

—Medium-Sized UK Asset Manager

What is clear is that the buy-side requires further education as to the benefits of conditional order flow if venues are to gain traction with the majority. Turquoise's Block Discovery service was commended for its simple parameters, incentivising larger size orders and resting times via the random periodic cross. However, there is an argument that if a broker has to firm up before the order is ready, more incentive exists for the buy-side

to keep flow in the main pool, and interact with the additional flow as and when it is available, rather than switching venues entirely.

Information Flows

The loss of advisory business will challenge traditional global investment bank offerings but may conversely provide new opportunities for those with unique information flows. As demand for best execution increases, those with greater visibility and insight will benefit. Yet less than a third of respondents are currently confident in the value of traditional access to broker information flows – IOIs – that they currently receive (see Exhibit 12). Nearly half the respondents were ambivalent about broker information, preferring to treat it with caution.

IOIs or Lie-o-Lies

The challenge is that this comes at a time when the buy-side has greater reliance on receiving meaningful information into multiple systems for effective analysis. As a result, a growing number of participants are increasing their dependency on internal capabilities to establish market activity rather than relying on information from their brokers. In addition, the information from their brokers requires a level of standardisation in

"While we don't trust IOIs, they still seem influential in where people choose to trade. IOIs stick and the broker will ultimately divvy up"

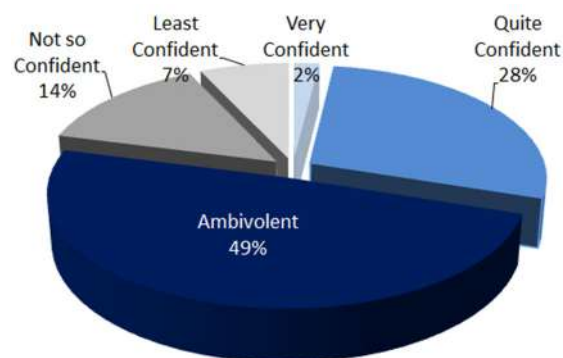
–Large UK Asset Manager

order to be of value. Nearly half the respondents see the introduction of formal rules of engagement as the most effective method to improve IOI offerings (see Exhibit 13).

The Association for Financial Markets in Europe and the

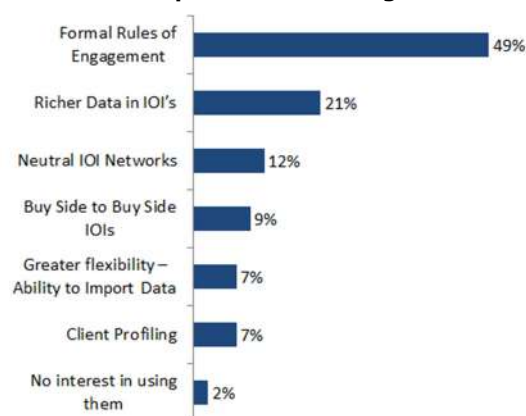
UK-based Investment Association recently announced a new set of codes to distinguish between IOIs. Those that can trade immediately without market impact will be labelled "client natural", and those that may incur information leakage and market impact will be labelled "potential". The theory behind this is that this framework will limit a broker's ability to fish for business and win orders on the back of a punt. By preventing misleading market noise, managers can establish where the natural liquidity is and obtain the best price to the benefit of their clients.

Exhibit 12
Levels of Confidence in Broker IOI's Currently Received



Source: TABB Group

Exhibit 13
Methods to Improve IOI Offerings



Source: TABB Group

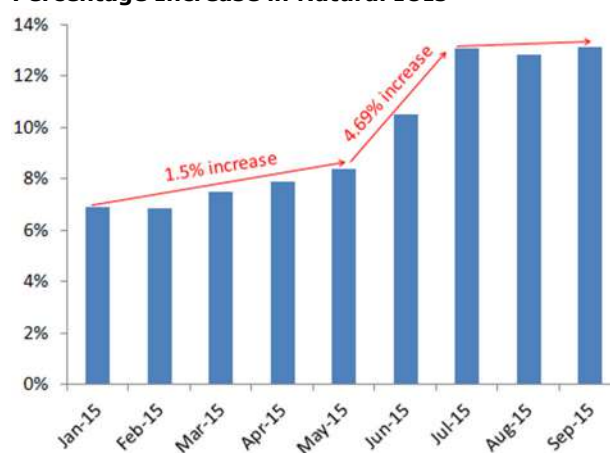
The success of categorising IOIs to ring-fence and thereby increase natural order flow was also highlighted in recent data provided by Thomson Reuters. Within the offering participants have

been able to categorise IOIs within four buckets; Natural, Natural Actionable, Actionable and Super. Typically general IOIs can be non-specific in relation to the exact size of the order (e.g. small, medium, or large) or the price, however a "Super" must stipulate both a price and a numeric size (e.g. 20,000 shares). This renewed commitment to greater information within the IOI but also sell side awareness of the importance of accuracy of information facilitated a jump in usage of natural IOI's this year (see Exhibit 14). This is anticipated to grow as the buy-side looks to seek alternative block liquidity opportunities independent of broker dark pools.

There is added impetus in finding alternative neutral IOI "market places" which could be independently verified given the inclusion of the misuse of IOI's as market manipulation under proposed guidelines for the EC's Market Abuse Regulation (MAR). While many agreed that if brokers are falsifying information and buy-side firms adjust their prices accordingly, this should be considered market manipulation, this then requires greater oversight. There are risks in taking indications rather than firm orders as a references as there can be erroneous inputs or delayed adjustments to trade updates, a natural client could even walk away if the portfolio manager chooses to pull an order. While brokers should not be penalised for the loss of natural orders, the view was that the inclusion of this under the MAR would encourage greater self-policing on the part of brokers. As such, 68% of respondents did not have concerns if IOIs are included as market manipulation under MAR (see Exhibit 15). Not ably, just 37% have taken action against a broker due to the perceived misuse of IOIs, as it is so difficult to prove abuse (see Exhibit 16).

"I agree-it is market manipulation-if an IOI is a lie, it is market abuse, why is it there?"
 -Medium-Sized UK Asset Manager

Exhibit 14
Percentage Increase in Natural IOIs

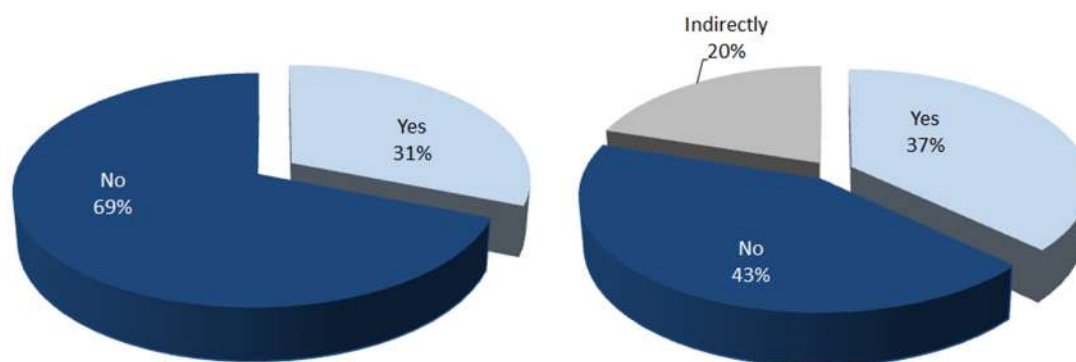


Source: Thomson Reuters/TABB Group

Exhibits 15 and 16

Concerns over the Inclusion of IOIs as Market Manipulation under MAR

Have You Taken Any Action Against a Broker Through Perceived Misuse of IOIs?



Source: TABB Group

IOIs and Best Ex

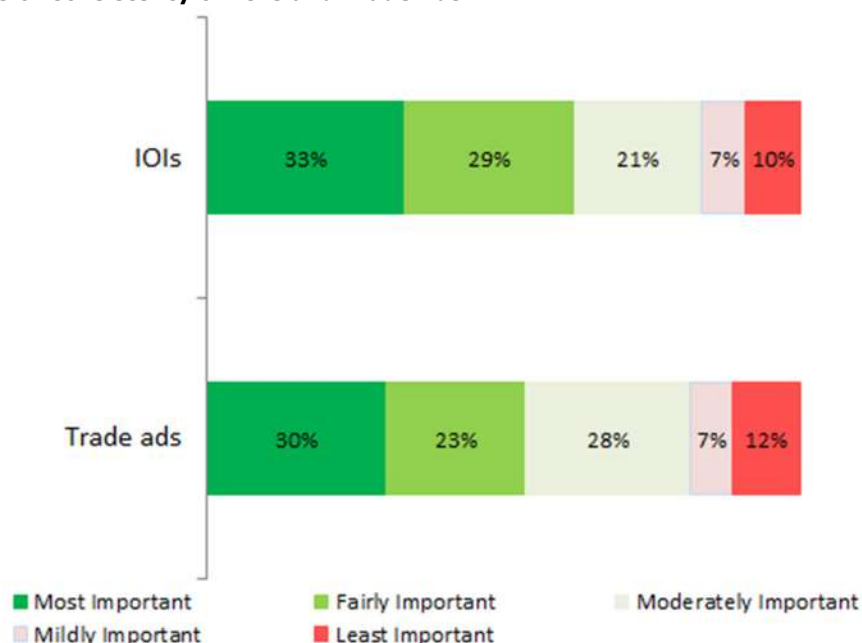
The rise in quantifying best execution measurement will increase the need for accurate and detailed information to be provided within IOIs by the sell-side in advance of the buy-side dealer opening up. Once this is made available, the decision process can improve, leading to better execution decisions. Some respondents have concerns that the current system encourages buy-side traders to rely on IOIs as a crutch rather than seek out true best execution. Currently, dealers often feel compelled to place the order with the broker once they have opened up, as they have already risked incurring information leakage by responding to the IOI.

"A broker being out on the IOIs doesn't necessarily mean that was the best price. But by the time you have picked up the phone and opened to them there is no incentive to go anywhere else"

-Large UK Asset Manager

Another issue with IOIs is the declining size of orders. Only being able to execute part of the order still leaves the buy-side dealer exposed to information leakage. As such, it is not only the information relating to IOIs that requires greater consistency; over 50% now place importance on the level of consistency in trade ads as well as IOIs (see Exhibit 17). The provision of more accurate data reflecting concluded trades offers valuable information that the buy-side trader can utilise ahead of selecting which broker to respond to.

Exhibit 17
Importance of Levels of Consistency of IOIs and Trade Ads



Source: TABB Group

Technological advancements will eventually offer alternatives. Traditional methods such as finding the broker that is the axe in the stock are already being replaced by traders carrying out greater market intelligence and price discovery ahead of placing the order.

As automation of the order process increases, the greater the quantity of data routed electronically, and the greater the opportunity to locate the requisite liquidity through data mining of fragmented message flow. Automated flows also increase the greater number and variety of participants you can potentially interact with, liberating buy-side dealers from a limited number of trusted counterparts. However, this will not mean blanket provision of all trade information to all participants. The increased use of data analytics to establish recent fund flows, trading activity and historical interest will facilitate targeted access to real-time information independent of the sell-side, exposing information only when it is necessary to do so. This ability to expand liquidity sources externally while maintaining control of how and when information is released will be the greatest opportunity for the buy-side to access natural blocks in the most efficient manner.

"The one buyer of the small mid cap stock you are trying to sell is a small manager in the West Country - before you couldn't reach them, now you can"

-Large UK Asset Manager

What Lies Ahead

The utopia of the block is re-emerging for multiple reasons. However, the creation of block liquidity will not automatically return to the block facilitation of old. Market structure make-up and the interdependent relationships between the buy-side, sell-side, exchanges and vendors have altered. The creation of block liquidity will need to adjust accordingly.

As depleted resources and regulation force investment banks to restrict capital commitment to the most profitable clients, the buy-side is readjusting trading behaviours, altering demand for services required and re-evaluating who they choose as providers.

However, liquidity cannot just pool on a venue – it needs to interact. Locating liquidity will be achieved through a more efficient dissemination of pre-trade information between market participants. But merely pulling asset managers together onto a single venue will not automatically conclude a trade. Negotiation takes time and skill, and buy-side paranoia tends to stand in the way. Large asset managers do not want to share or disclose their trading intentions for fear of being run over. The question is whether this requires sell-side brokerage or whether neutral vendor networks or even peer-to-peer networks can now facilitate trading.

As volatility increases it will become harder to get blocks away without some sort of facilitation, unless the information chain can improve communication between opposing sides of the market. Traditional methods of trading on lit exchanges remain unattractive to institutional order flow, as exchanges have concentrated on alternative revenue streams and attracting high-volume order flow. Traditional access to information flows from brokers has also lost its appeal due to the lack of confidence institutional investors place in the information received. Once the buy-side has the capability to accurately identify the quantity and type of flow being interacting with, they are more likely to respond, irrespective of the market participant or venue where the block can be facilitated.

While many remain sceptical of the success of vendor or peer-to-peer networks given historic experience, the evolution of capital markets may now be better placed to support new models. Much has been discussed regarding the equification of fixed income, currencies and commodities markets, but fixed-income trading behaviours could now lead the way in block facilitation. In a similar manner to vendor negotiation models such as Liquidnet and ITG Posit, portfolio negotiation could be extended to a larger proportion of equities trading in a similar way as peer-to-peer bond portfolio adjustments are today.

However, access to accurate and timely information will be of greater value than merely recreating the ability to trade blocks. The requirement to deliver and demonstrate best execution will necessitate the provision of greater accuracy and quantity of information to make the decision to trade a block or not. It may be more advantageous to execute the trade over a period of time if there is significant order imbalance or high market momentum.

As market volatility increases, buy-side firms will need to capitalise on opportunities as and when they become available to them. This will require greater information flows and improved accuracy and standardisation of this data. The development of better tools to locate and manage information flows will be the first step in the process of bringing back the block.

About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of first-person knowledge, TABB Group analyzes and quantifies the investing value chain, from the fiduciary and investment manager, to the broker, exchange and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their businesses. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, visit www.tabbgroup.com.

The Author

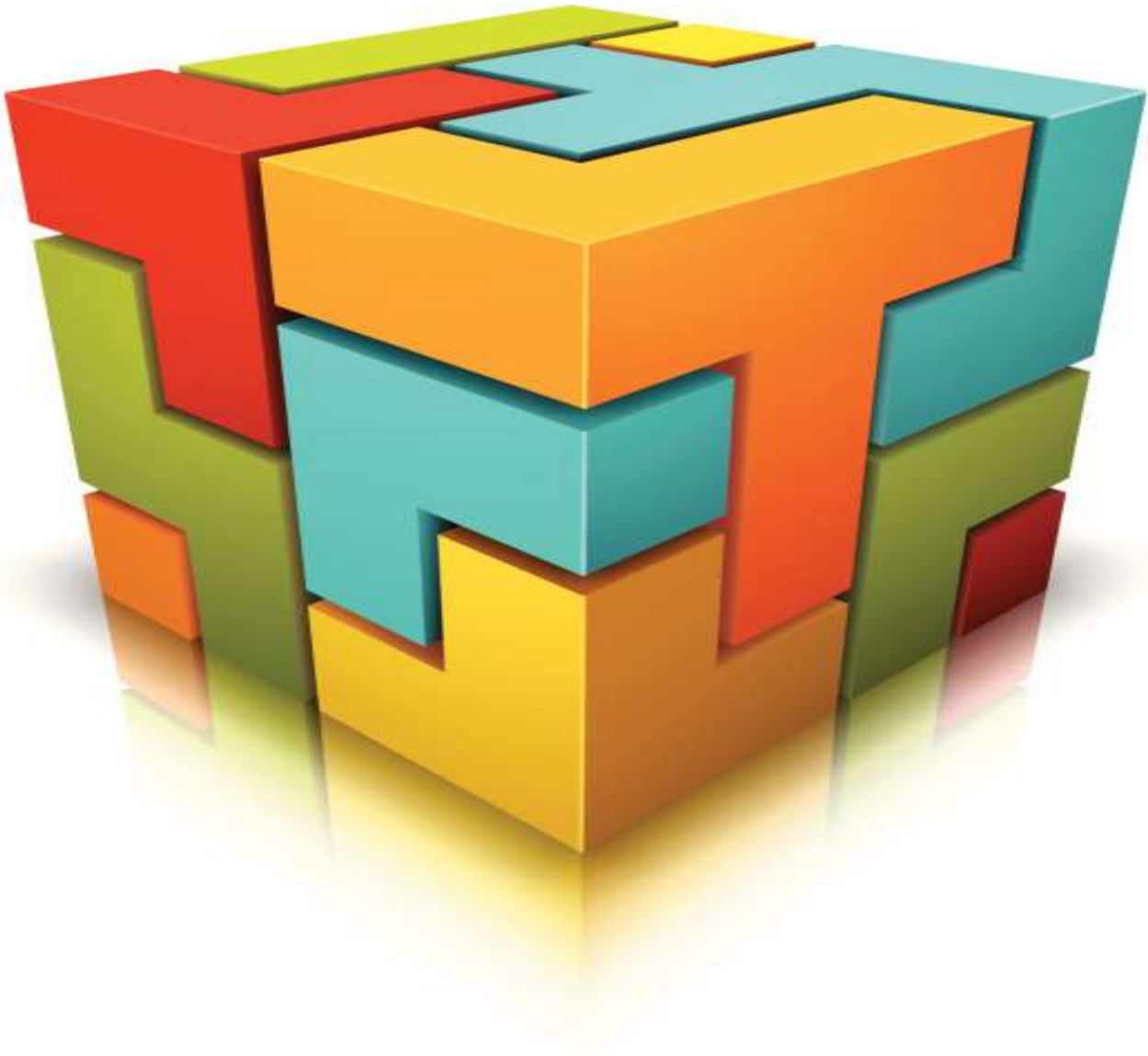
Rebecca Healey

A recognized thought leader in market structure, regulatory reform and financial trading technology, Rebecca Healey joined TABB in March 2011, bringing over 15 years of direct industry experience in e-trading and financial services. Widely quoted in the financial, business and trade media, she has appeared on TV and radio discussing ongoing changes in capital markets for the *Financial Times*, *The Wall Street Journal*, *The Times*, *DeTelegraaf*, *Het Financieele Dagblad*, *ILSore24*, *Handelsblatt*, *Finanz und Wirtschaft*, *L'Agefi*, *Le Monde*, *Les Echos*, CNBC TV, BBC TV, BBC Radio, Bloomberg and Reuters, among others. In 2012, Rebecca was invited to provide evidence for the UK House of Lords review into electronic trading and regularly contributes to wider debates on regulatory reform.

Rebecca has held various sales and trading positions with Bankers Trust, Goldman Sachs and Credit Suisse, where as vice president she was instrumental in launching the firm's successful Advanced Execution Services product to hedge funds from its inception in 2002 until 2008. Prior to this, she was the first electronic trader at Credit Suisse to be registered for all electronic European cash equity markets and covered sales trading into Asia and then Europe between 1997 and 2000. More recently, she was based in the Middle East from 2008 to 2010, employed by the British Embassy in Bahrain where she successfully launched the UK Government's financial services strategy and set up the Bahrain Financial Services Roundtable, which remains a key source of information for the UK Government today, especially in relation to Islamic finance.

Rebecca holds a Bachelor of Arts degree in Spanish and Latin American History and Politics from the University of London.

At TABB Group, Rebecca has authored an expanding catalogue of research papers and commentary covering European equities, FX, fixed income, dark pools, TCA, HFT, FTT, market surveillance, market structure and regulatory reform.



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