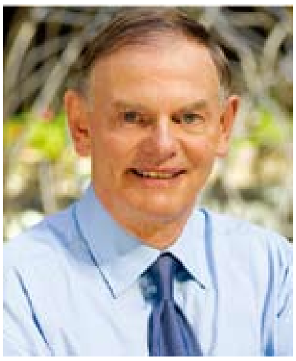
Finding solutions

Now in its 5th year, the FPL conference in Canada tackles the tough issues

What a lot can change in a year! Since the last FPL Canada conference, held in May 2008, Canada has been drawn into the liquidity crunch along with the rest of the world. Yet Canada has a risk and regulatory model that is different from many of its established trading partners, most notably the US and the UK. Can the world learn lessons from the Canadian experience?



By **Robert Smythe**, *Stratix Consulting*

With only weeks to go until Canada's leading electronic trading event, it is still hard to pick what the credit crisis and regulatory environment will look like on June 1st, the first day of the conference. What we do know is that there will be increased regulatory involvement, particularly in areas that were previously not subject to scrutiny. In the run up to the event, we asked a range of experts to comment on what they feel will be the hot topics at this year's event.

Conference Hot Topics

(A) Market Volatility

Market volatility has certainly changed trading patterns. The increasing reliance on electronic trading, leveraged through Direct Market Access/Algorithmic Trading or a portfolio trading desk, is directly connected to the growing need to manage risk, volatility and capital availability. We have seen a dramatic uptake in these services/tools, as there has not only been a focus on how electronic trading is conducted, but also on the expectations of trading costs involved versus benchmarks. The greatest impact has been a higher use of electronic trading strategies relative to more traditional trading and a shift in the types of electronic trading strategies employed.

From a single stock perspective, many traders were loath to execute at single, specific price points due to the potential for adverse percentage swings in the high single to double digits. Algorithms have been employed on a more frequent basis, to help traders participate throughout intervals on an intraday basis, managing risk around the volatility. The violent intraday swings also create significantly more opportunities in the long-short space. Quantitative execution tools have became more of a focus, to take advantage of these opportunities on an automated basis.

What the industry is saying:

"In terms of disruptions relating to market volatility, the Canadian trading infrastructure generally held up admirably.

Most dealer, vendor, and marketplace systems handled the massive increases in message traffic and activity with little noticeable impact on performance. This is proof positive that the investment in capacity and competition was well worth it and is now paying dividends." *Matt Trudeau, Chi-X Canada*

"Electronic platforms using FIX and algorithmic routers handled significant market fluctuations with no impact to performance. Speed to market for orders made it possible for traders to minimize exposure to huge swings in pricing and to capitalize on opportunity." *Tom Brown, RBC Asset Management*

"Many traditional desks were shell-shocked and did not know how to respond to the volatility combined with the lack of capita. Electronic trading tools like algos enabled people to manage extremely volatile situations with great responsiveness. They were able to set the parameters for their trades and let the algo respond as market conditions warranted. Trading of baskets/lists made having electronic execution tools critical. You couldn't possibly manage complex lists in real-time without very sophisticated electronic front-end trading tools." *Anne-Marie Ryan, AMR Associates*

"The recent volatility spike means that risk will likely be scrutinized more in the future than in the past. Post-trade transaction cost measurement systems generally do not consider risk but instead focus on cost. To properly align the interests of the firm and the trader, performance measurement systems will need to reflect both cost and risk considerations." *Chris Sparrow, Liquidnet Canada*

Jenny Tsouvalis of Ontario Municipal Employees Retirement System (OMERS) sees a need for effective integration of investment management and trading processes. "On-line, real-time electronic trading systems provide quick access to liquidity and when coupled with real-time pricing embedded into blotters, identify the effect of market changes on the portfolios and the effect of trading decisions."

"Electronic trading has been successful because of its ability to be adaptive, so it is likely to change in reaction to current issues." *Randee Pavalow, Alpha Trading Systems.*

"We've seen an increase in the use of algorithms and over the day orders as volatility has increased. The ability to smooth orders over a longer period limits the exposure to price swings during the day. VWAP, TWAP and percentage of volume, seem to be the algos of choice for many these days." *John Christofilos, Canaccord Capital*

(B) Algorithms and Smart Order Routing

Smart order routing is still relatively new in Canada; however alternative trading systems and exchanges are now becoming part of the trading landscape. While the technology solutions are there, effectively deploying them in Canada requires further development. Presentations at the conference will focus on methods to source liquidity at the primary exchange and via the five alternative trading venues.

What the industry is saying:

"Significant progress has been made in multiple market connectivity and smart order routing capabilities during the past six months, but there is still a lot of distance to make up compared with other jurisdictions. Participants need to have greater flexibility and control when it comes to order routing." *Matt Trudeau, Chi-X Canada*

"The inability of secondary trading venues to accommodate volumes and provide liquidity during primary market disruptions, raised questions as to secondary providers having sufficient connectivity to all market participants and the lack of price discovery transparency." *Tom Brown, RBC Asset Management*

"Algorithmic trading technology really proved itself during a primary market outage. Clients were able to execute their strategies on Canadian inter-listed stocks seamlessly. Orders were posted in the United States, and if better prices were available in Canada, the algos grabbed them. However, few clients were willing to post bids and offers in alternative markets when no one else was." *Lou Mouaket and Graham Mackenzie, CIBC World Markets*

"Electronic Trading, like traditional trading, is at the mercy of the exchanges being able to post bid and offers and execute orders on a timely basis. Once that connection is disrupted, the ability to order route to other markets through a "Best Market Router" becomes more important. Within a multiple market environment, the ability to execute client orders on other markets has become a must for dealers and clients." *John Christofilos, Canaccord Capital*

(C) Regulatory Initiatives

An indication of the regulatory climate is the proposal by European leaders for sweeping new market regulations to be discussed at the April 2, 2009 summit of the Group of 20. These include sanctions on tax havens, caps on bonus payments, and regulation of hedge funds and rating agencies.

While sweeping global regulatory issues are being debated, it is equally important that regulatory processes, designed to increase the efficiency of capital markets processes in Canada, continue. These include initiatives to enhance marketplace operations by the Canadian Securities Administrators and the Investment Industry Regulatory Organization of Canada (IIROC) which has a role similar to FINRA in the US.

Now that multiple marketplaces exist in Canada, more clarity must be established around what constitutes best execution and trade through protection. Key to this is the availability of an information processor for both corporate debt and equity securities. Deliberations have been underway since 2006, and in January 2009, the regulators issued a request for potential information processors to amend their previous submissions. The plan is to review these updated submissions in the first half of 2009.

What the industry is saying:

"During primary market disruptions, Canadian dealers' inability to port their passive liquidity from the primary market to the alternative marketplaces has highlighted the importance of primary market supply and demand in the price discovery process. Without a NBBO representing a majority of outstanding orders, traders are left without a compass, and automated systems such as smart routers and crossing networks were unable to operate effectively." *Wendy Rudd, TriAct*

"One of the challenges resulting from market fragmentation has been the difficulty of data consolidation. Consolidated quotes, live consolidated trade tapes, and post-trade consolidated feeds are all essential for trade transparency, regulatory compliance, and relevant trade analytics. Today there is no market standard or consolidated provider.

Some market participants consider this lack of consolidation a regulatory failure while others wait for the largest market players to pressure vendors for a consolidated tape." *Alison Crosthwait, ITG*, in her paper, 'Is Chaos Good?'

(D) Risk Mitigation and Operational Efficiency

Risk mitigation and operational efficiency definitely deserve increased attention in 2009, and June's conference will provide attendees with the latest thinking on these important areas.

There is a growing belief that market participants must be thoroughly versed in the automated electronic tools required for intelligent market connectivity, achieving best execution, managing risk and achieving cost reductions. This is being driven by the increasing complexity of the Canadian market and the need to control risk and reduce costs in these turbulent times.

What the industry is saying:

"In the current market environment, capital scarcity has resulted in a significantly decreased appetite to facilitate client block and basket trading on a liability basis. Forced to work orders into the market, traders have turned to algorithmic trading to manage the risks associated with transacting medium to significant sized orders. With the reduction of capital and ensuing smaller percentage of block trading, cash traders are finding themselves utilizing the electronic suite of tools that were previously only relegated to program trading desks." *Lou Mouaket and Graham Mackenzie, CIBC World Markets*

"Connectivity platforms that bring together various liquidity pools need to be enhanced. Workflows need to support real-time capabilities to provide traders with as much information as possible as it is occurring in the marketplace." *Jenny Tsouvalis, OMERS*

"All trading venues must fully participate in providing liquidity and price discovery. Increased global competition, fee reductions and increasing market volatility requires trade flow monitoring that supports timely TCA reporting." *Tom Brown, RBC Asset Management*

"Traders need to have ready access to, and familiarity with, a variety of tools to use when market conditions are more than any human can handle. Proven algorithms – tailored to local market characteristics, with access to a cross-section of dark and light markets, with appropriate checks and balances to manage risk – can be indispensible during challenging markets. As more traders discover the utility of electronic trading tools as a matter of necessity, their use under "normal" market conditions will grow as well." *Wendy Rudd, TriAct Canada*

"Operational risk must start at the beginning of the trade cycle and not just via post-trade clearing/settlement processes. To manage risk and control costs, the monitoring process needs to start when a buy or sell decision is made and information gathered throughout the trade process. This means use of an OMS feeding an EMS or at the least, an EMS.

Best execution takes even greater importance as everyone with fiduciary responsibility will have to be able to demonstrate how they are acting in their client's interest. The ability to provide a complete audit trail of how orders have been managed requires the use of electronic trading tools throughout the trade process." *AnneMarie Ryan, AMR Associates*

"Just five years ago, trading on the Toronto Stock Exchange (TSX) alone was sufficient to fulfill the perception of best execution. Today, the picture has changed dramatically with several new marketplaces. As this trend continues, trading in Canada will involve a greater focus on connectivity, algorithmic trading, and the need for institutional investors to ask new questions of their brokers to assess trading prowess." *Alison Crosthwait, ITG*

"Electronic Trading is here to stay and will only grow as markets become more fragmented and the need to discover liquidity becomes more important. Electronic trading has always shown strong growth in volatile markets as customers take more control of their orders and look to tools that will alleviate any additional volatility that traditional trading may impose." *John Christofilos, Canaccord Capital*

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