

Trade execution

It is common knowledge that the US and European markets do not look alike from a trading perspective. While traders in Europe commonly access liquidity in a central point and concentrate on minimising market impact, in the US the difficulty is to find where all available liquidity resides and re-aggregate it into a single trade. “These are two very different ways to trade, requiring different skill sets,” says Frédéric Ponzio, managing director at research consultants NET2S Group.

Another major difference lies in how liquidity gets rewarded and how transaction fees are levied. In Europe, in general, exchanges levy a ‘per transaction’ fee, “which gives you an incentive to make your orders larger before you send them to the exchange,” says Octavio Marenzi, CEO and president, Celent. In the US, where the fees levied by the exchanges and ECNs are on a ‘per stock’ basis, the cost of trading is significantly lower than in Europe. This tends to make US orders smaller in size and higher in frequency.¹

In the US, ECNs provide liquidity rebate. “You actually get paid prior to execution when an order you send to the ECN goes into the order

Is the pond shrinking?

Will Reg NMS realign the US markets and make them more familiar to European traders?

Alan West

book,” says Marenzi. “There is payment for order flow,” he explains. There is also market data revenue sharing between ECNs and investment firms.

However, use of the central limit order book in Europe makes its central market mechanism more efficient than the US, contends Tim Wildenberg, managing director, head of direct execution services, Europe, UBS Investment Bank. The way that central limit order books function attracts more liquidity. “This is almost a self-fulfilling prophecy,” he says. “It could be argued that the arrival of ECNs in the US was effectively the market’s answer to an inefficient market mechanism,” he notes. “Similarly, the failure of ECNs and other alternative liquidity sources in Europe is testament to the high functionality of the market mechanism.”

At the same time, there are major differences in the way stocks trade on the NYSE and Nasdaq. “The

NYSE is about a hundred times slower,” says Marenzi. “While the NYSE specialists, who are the dominant pool of liquidity on the exchange, tend to take between 5 and 10 seconds to execute a trade, the most liquid stocks on Nasdaq are executed in about 0.2 to 0.5 seconds.”

A comparison of two recently released Celent reports on equities trading in the Nasdaq and NYSE markets shows that while ECNs offered the fastest execution times for Nasdaq-listed stocks and market makers offered the greatest price improvement over and above the NBBO, there was no such trade-off between price and speed on the NYSE. “That is simply because the specialists are both slow and command poor prices,” says Marenzi.

In Europe, differences in the functioning and level of service on the main exchanges do not appear so pronounced. “One reason for this is the technology,”

¹ For a detailed analysis of how high frequency trading models make it more difficult to find other natural buyers or sellers directly, see ‘Going with the flow’, page 22.

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explains Ponzo. The technology used to run the platforms of all the main exchanges is European. The principal vendors are Deutsche Börse, Euronext and OMX. “None of these are American,” he says.

Europe’s apparent advantage in technology is attested by the ubiquity of the NSC, the Euronext platform. “The NSC system is probably the most widely used platform in the world,” says Ponzo.

“As well as Euronext, the Toronto Stock Exchange, Sao Paulo, the Chicago Mercantile Exchange, and the exchanges in Lebanon, Mexico, Morocco, Tunisia, and Warsaw, all run on it,” he says. A staggering 20% of Euronext’s revenue comes from license fees levied for access to its NSC system.

The impact of Reg NMS

Regulation clearly plays a role in shaping market structure. Reg NMS stipulates that firms must achieve best execution, which it equates with best price, by accessing all available execution venues. Doing so is a challenge that is already there independently of Reg NMS, argues Ponzo. “Reg NMS doesn’t change the fact that the US market has multiple listings and that overall



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it’s price-driven, not order-driven.” Nasdaq, for example, is “not a proper auction/quotation platform like SETS or NSC,” says Ponzo. “You don’t place orders on Nasdaq; market makers position quotes that are tradable,” he points out.

However, Reg NMS promises to bring an order-driven flavour to the US market. It will not reduce the number of different liquidity pools but it will standardise the rules they comply with. “There will be greater transparency of the order book and greater depth, enticing the buy-side to actually show their hands more,” says Ponzo.

The fees firms pay to exchanges, ECNs, or other liquidity venues when they trade through them will be capped and harmonised.

While this will have little impact on traditional asset managers, it will affect hedge funds because they like to trade directly on the market instead of going through brokers, as much as they can.

Traders will also be able to pick and choose the market data they want instead of buying the whole market. Also, if they want, they can get Level 2 data for market depth. Today, if you want to get the full depth of all the liquidity, quantities, prices, offers, and asks, you need to buy for every single stock. “This is crazy; it is way too expensive for an asset manager,” says Ponzo. “With the new rule you will be able to pick and choose the sectors, industries and sub-segments of the market from which you want either summary data or full market depth,” he adds.

“Part of the object of Reg NMS is to enable execution strategies to be applied which are closer to the more transparent, order-driven market that exists in Europe,” says Ponzo. “Reg NMS won’t make it harder for traders in Europe to access the US market. On the contrary, it will make it clearer for buy-side traders to ascertain how their brokers are going to execute their trades.” ■