SUNGARD VALDI

THE EVOLVING ROLE OF THE BUY-SIDE TRADER

How the Sell-Side Can Provide Value in a Rapidly Changing Market

TABLE OF CONTENTS

1 Introduction

1 Challenges to the Buy-Side Trader

1 Market Regulations

2 Liquidity Challenges

2 Demise of the Bulge Brackets

3 Decreasing Spending on Technology

3 Global, Multi-Asset Market Access

3 How to Meet Buyside Challenges

4 Stay Ahead of Regulatory Changes

4 Leverage Scaleable Technologies to Meet Changing Market Conditions

4 Provide Global, Multi-Asset Trading

5 Provide Front-to-Back Trading and Risk Management Over the Entire Trade Lifecycle

5 Embrace Technology, but Recognize the Power of the Human Element

6 Choosing the Right Technology Partner

6 Conclusion

INTRODUCTION

Several recessions, a severe credit crisis, heightened regulatory oversight, declining market volumes and a squeeze on margins have made the last decade a sobering one for investment managers and sell-side firms. As one industry practitioner stated in *Traders* Magazine," The common denominator between the buy-side and the sell-side is pain."[1] Fortunately, such pain can be alleviated by sell-side firms renewing their commitment to trading technology solutions.

Although there have been many changes in the trading landscape, the buy-side has become savvier about execution venues, algorithms and best execution strategies over the past decade. This knowledge, once the sole property of the sell-side, has given the buy-side more independence. The buy-side is no longer content to rely on standard sell-side services such as execution, capital commitment, research and market access. The buy-side wants value from their sell-side relationships and they want the sell-side to justify the costs of having them execute their trades.[2] With efficient and effective direct market access to multiple trading venues, the buy-side is questioning the value provided by the sell-side at all. It is a legitimate question, and one that the sell-side must be prepared to answer correctly to avoid further disintermediation.[3]

The good news is that the sell-side can continue to play an important role in buy-side trading and re-capture revenue; however, it needs to do this by broadening its menu of buy-side trading solutions in three important ways. First, the sell-side must address buy-side cost pressures by providing a cohesive front- to back-office trading service that delivers economies of scale to reduce buy-side trading costs and supporting the buy-side's ability to make trading and investment decisions that will boost revenues. Second, the sell-side must proactively support market structure and regulatory changes and, as a result, foster trust and transparency. Third, the sell-side must provide the global, multi-asset trading capabilities that buy-side firms are demanding as they expand trading to include emerging and frontier markets.

CHALLENGES TO THE BUY-SIDE TRADER

For buy-side firms, some of the changes in the trading market may seem overwhelming. New trading venues — both displayed and non-displayed — have complicated how the buy-side will trade. There are stringent regulations that seem to change almost daily, causing buy-side traders to scramble to keep compliant. As costs are increase, market volumes are declining while exponential growth in market data places greater stress on their technology infrastructures. Pressure to expand their product offerings beyond equities and into new and global asset classes, such as derivatives and options, requires execution expertise they may not have. In a landscape fraught with market fragmentation, sourcing liquidity can become difficult. Buy-side firms are also reducing their investments in technology to mitigate costs, which is having a negative impact on market innovation.

Market regulations

In light of the "Great Recession," the devastating credit crisis of 2007-2008, and high-profile trading fraud such as the Ponzi scheme perpetrated by Bernie Madoff, regulators, including the Securities Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA), are clamping down on the trading industry to ensure that both sell-side and buy-side traders are fully compliant. For example, in 2009, the SEC built up staffing in its newly created Division of Risk, Strategy and Financial Innovation to ensure that traders are improving risk management and enhancing data quality to provide transparency into their execution and risk management activities. While increased transparency is a positive step forward for the financial industry as a whole, increased regulations translate into increased costs and diminished profits for buy-side traders.

While regulators are scrutinizing many trading activities, there are a few that are of particular concern. One high-profile regulatory target is high frequency traders. Although high frequency trading firms represent only about 2% of the approximately 20,000 U.S. trading firms, these firms account for 73% of all U.S. equity trading volume, up from 30% in 2005.[4] These traders have been vilified in the media as being a cause of the financial crisis and are becoming a lightning rod in Congress for all that is wrong with the financial system.[5] For example, the SEC is currently pondering whether or not to require a high frequency trader to put controls in place to prevent erroneous orders, ensure compliance with regulatory requirements, and enforce pre-set credit or capital thresholds. For the buy-side, this proposal would make high frequency trading more difficult and expensive than it already is.

Another hot topic for regulators is active indications of interest (IOI).[6] An IOI enables traders to send a message stating that they are interested in buying or selling a specific number of shares. Some traders in the industry expound the benefits of IOIs, while others believe that they provide unfair advantage and concerns about information leakage. "IOIs are not going away, as they serve an important purpose," explains Sang Lee of the Aite Group. IOIs are a trade-off between fulfillment rates and information leakage: advertising what's in a crossing network via an IOI improves the chance that the order will be matched, but increases the risk that information about the order will be compromised.[7]

Finally, regulators are taking a close look at dark pools. The SEC is currently gathering proposals from the industry on how to increase transparency of these essentially private trading systems.[8] For the buy-side and the sell-side, dark pools, while more difficult to navigate than publically displayed venues, are becoming an important component of achieving best execution. The buy-side in particular needs access to either smart order routing or a sell-side broker to provide the direction and speed required to navigate through these liquidity sources. Aite Group predicts that the top four displayed execution venues (NYSE, Nasdaq, BATS and Direct Edge) will maintain their 80% market share, but that the amount of liquidity found in dark pools will continue to increase. In 2004, only 3.1% of liquidity was found in dark pools. By 2008, that percentage jumped to 8.4% of total market liquidity.[9] Dark pools are a reality that the buy-side cannot afford to ignore in their search for liquidity.

Liquidity challenges

Ten years ago, the trading landscape consisted of a handful of trading venues. Today, there are more than 50 trading venues offering both displayed and non-displayed liquidity, each with specific rules and intricacies. Even across the exchanges, more than 650 different pricing structures exist. According to Aite Group, each dark pool interacts with other venues differently, and can be confusing for traders to figure out the order flow and the degree of the exposure of each venue.[10]

The rise of dark pools, electronification networks (ECNs) and other execution venues have fragmented liquidity and diminished the supremacy of exchange.[11] Although fragmentation can be seen as a hurdle to be jumped, fragmentation does disperse risk by distributing volumes over many venues. It also creates a competitive marketplace where venues must compete against each other on cost, price, liquidity and latency. This makes it more difficult for the buy-side to find liquidity and minimize the market impact of trading large orders in an increasingly fragmented market.

Demise of the bulge brackets

Would anyone have predicted the demise of some of the most storied bulge bracket firms? In 2008, the industry watched in awe (and perhaps in horror) as stalwart firms such as Lehman Brothers, Bear Stearns and Merrill Lynch were acquired or simply dissolved. The trading landscape has decidedly changed and remaining firms have been jolted into the realization that business cannot go on as usual.

For buy-side firms, the landscape has changed as they contemplate new sell-side entrants into the market. The high-frequency trading firms once content to take a backseat to bulge bracket firms, such as Goldman Sachs and JP Morgan Chase are flexing their muscles and giving the sell-side a run for their money. These firms have fine-tuned their trading models and low-latency technology infrastructures. High frequency trading firms are now responsible for more than 60% of average daily volume in U.S. equities, and provide a very real choice for buy-side trades.[12]

Decreasing spending on technology

An increase in the number of execution venues has given buy-side firms even more trading venues from which to choose. However, the increased diversification of order flow has increased costs for the buy-side. Some of the largest buy-side asset managers spend hundreds of millions of dollars per year on trade processing. These costs are a drag on fund performance. Therefore, buy-side firms are desperate to reduce costs while continuing to trade with different algorithms, dark pools, sell-side firms and venues.[13]

As a result of increased costs and the 2009 recession, buy-side firms have had to reduce the amount they spend on trading technology to help them navigate these new trading realities.[14] These cutbacks on internal IT allocations will hamper innovation in the market and the provision of various services to the buy-side.[15]

Global, multi-asset market access

As a firm's need for global and scalable solutions increases, they require flexibility to integrate new types of instruments and build cross-asset trading platforms. In addition to trading equities, fixed income and commodities worldwide, derivatives, options and futures are becoming must-haves for the buy-side trader as these instruments play an increasingly important role in global markets. In 2007, exchange-traded options volumes in the U.S. averaged more than 11 million contracts per day. By October 2008, the average daily volume had increased by 28% to 14 million contracts per day.[16] In addition to exchange-traded instruments, the buy-side needs to be able to trade OTC instruments as well.

With multiple systems operating in many of today's firms, it is no surprise they struggle with achieving global multi-market access. First, global multi-market access requires not only multi-currency and multi-access trading capabilities, but also real-time market data for major markets. Managing these workflows and integrating information across multiple systems is time-consuming and error prone, especially when compared to the ability to execute multiple global orders through a single order blotter.

HOW TO MEET BUY-SIDE CHALLENGES

The lights may have dimmed and the atmosphere may not be as raucous, but the sell-side can continue to bring value to the buy-side. To do so, the sell-side will need to focus on implementing trading solutions that enable it to stay ahead of regulatory changes, leverage a scalable infrastructure that can adapt to changing market conditions, and access global, multi-asset trading. Sell-side firms hoping to attract buy-side clients will need to invest in technology that offers front- to back-office trading and risk management over the entire trading lifecycle to give buy-side firms a technological edge while retaining the human element. At the end of the day, technology should help the buy-side trade better, whether they choose to trade electronically or manually.

Stay ahead of regulatory changes

With regulatory change occurring at a faster pace, the buy-side is scrambling to keep up. It is no longer adequate to simply react to regulatory changes. The buy-side will increasingly need to anticipate impending regulatory changes that will impact how it accesses markets and reports its data. If buy-side firms are consistently reacting to regulatory changes, they will quickly fall behind. The answer is to partner with a sell-side firm that has a demonstrated ability to stay one step ahead of regulatory changes.

A recent ruling by the Financial Services Authority (FSA) in the U.K. highlights how quickly the regulatory environment can change — and how quickly buy-side firms are expected to comply. In January 2010, the FSA gave all trading firms just 40 days to meet onerous data requirements for new liquidity reporting. While the sell-side is accustomed to providing details such as the amount of cash on hand, buy-side firms will likely find it difficult to pull this data from their existing applications and databases.[17]

Just as the sell-side needs to keep its finger on the pulse of the evolving regulatory environment, it also needs to offer the buy-side a solution that will help them proactively identify internal regulatory problems before they become critical. For example, the solution should provide visibility into potential risk factors, both at the individual trader level as well as firm-wide adherence to regulations such as Reg NMS, and alert the buy-side if there is any danger of non-compliance.

Leverage scalable technologies to meet changing market conditions

If buy-side firms have learned one thing from the recent economic downturn, it is that they need to have a sell-side partner with the right capacity and appropriate investment in technologies that let them respond quickly and reduce their risks when the markets change. The downturn was hardest on those organizations that invested too heavily in internal infrastructure, systems and overcapacity. When the market took a nosedive, it seemed as if many firms were left trying to sell off assets and close facilities — usually at a loss.[18]

However, current technology infrastructures are likely to fall short as market data volumes increase. Aite Group expects market data volumes to continue to grow exponentially and further strain market data infrastructures. It predicts that message volumes will average 1.2 billion messages per day by 2011.[19]

High volatility and high frequency trading generate enormous amounts of quote, order and market data that must be gathered, analyzed and stored. But the buy-side is challenged to spend more dollars on new technology. They want technology that will provide an edge, but will be hesitant to invest in these technologies themselves. According to the TABB Group, the buy-side must spend on technology to survive in this changing market, but the spending undermines their profit margins.[20] To add value, a sell-side partner must offer technologies that will provide buy-side firms with the best execution, access to liquidity, and lower transaction costs. These technologies should include a robust Execution Management Systems, smart order routing, global connectivity to multiple venues including ECNs and Alternative Trading Systems, and algorithmic trading engines.

Provide global, multi-asset trading

To meet the needs for buy-side firms to trade in many asset classes across the global marketplace, sell-side firms must demonstrate the ability to connect to a multitude of exchanges, brokers and buy-side firms around the world. They must also trade in a wide variety of instruments such as equities, fixed income, futures, derivatives, commodities and options on exchanges worldwide. As the buy-side becomes more comfortable trading in emerging and frontier markets, the sell-side must be ready with access and connectivity to equities, options and other instruments in these new markets.

To provide global, multi-asset trading for buy-side firms, sell-side firms should provide solutions that support full lifecycle trading and trade processing activities, including information services, market connectivity and order management, to help improve trade efficiency and risk monitoring. As the need for global and scalable solutions increase, firms also require flexibility to integrate new types of instruments and build cross-asset trading platforms. Buy-side and sell-side technology must enable a seamless handover of market data, transaction pricing, and more. In addition, the use of a single platform can help reduce the number of disparate systems and data feeds, while helping users to reduce trading costs, simplify infrastructure, improve order flow, and offer a more diverse range of services to clients.

Provide front-to-back trading and risk management over the entire trade lifecycle

Trading is, by nature, a complex business. To trade efficiently, all the pieces of the trading lifecycle must work together, thought the integration effort needed to make these disparate systems "talk" can be a challenge. Many buy-side and sell-side firms are recognizing the advantage of a single vendor platform that can provide front- to back-office trading, from pre-trade risk to post-trade analytics.

A sell-side firm offering a single, integrated platform for global multi-asset trading, as well as the additional capabilities and support their clients require, allows buy-side traders to spend more of their time focusing on investment, trading and business strategy, rather than underlying technology. In addition, a sell-side firm offering integrated tools and solutions into a buy-side firm's existing infrastructure can save that buy-side firm the time and money that normally would be required to do this integration internally.

Embrace technology, but recognize the power of the human element

Technology plays a critical role in today's trading environment, but even the most advanced algorithms have limitations. For example, a single buy-side client may have portfolio managers with different trading strategies. While price improvement and low transaction costs may be important to one manager, another may name anonymity and lessened market impact as most crucial. Although technology such as algorithmic trading excels at executing some trade strategies, other strategies require a skilled trader. There is no one-size-fits-all approach to trading, and a sell-side partner that can offer both a low-touch and a high-touch approach to trading provides value to the buy-side.

One way that sell-side firms can balance their approach is to differentiate their algorithms, educate the buy-side on their use, and perhaps even customize algorithms to meet changing buy-side needs. A recent TowerGroup report stated, "The buy-side trade desk must have a strong knowledge of the operating and business models of the various execution venues and the way algorithms work with dark pools, exchanges, and ECNs. If a broker does not enhance its algorithms…the buy-side will direct order flow to brokers that do."[21]

The trend towards algorithmic trading and cheaper electronic trading channels will continue. The TABB Group states that buy-side firms increased their use of algorithms in 2009 to 31% of their share volume, up from 24% in 2008 and 22% in 2007.[22] This increase will bode well for the sell-side if it can demonstrate the value of low-touch trading services and increase its commissions. By bringing value back to the trading relationship, a 10% increase in sales trading would result in more than $1 billion in annual commission revenue.[23]

CHOOSING THE RIGHT STRATEGIC TECHNOLOGY PARTNER

To succeed in today's uncertain financial environment, sell-side organizations need on-demand, end-to-end, global multi-asset trading solutions. Ideally, firms should engage with a strategic partner that offers deep experience in managing all aspects of liquidity, order, trade and risk management, analytics, compliance and network connectivity solutions.

Innovative trading solutions can help sell-side firms achieve increased performance, low latency, and best execution across multiple platforms, instruments and geographies. They can eliminate or reduce their trading costs by executing trades through execution and routing solutions. In addition, the sell-side can use these solutions to make smarter and faster trading decisions, turn options risk into earnings, maximize the trading experience with one execution point providing access to a diverse pool of liquidity, and improve efficiencies by automating the trading and distribution of fixed income securities and money market instruments. By employing an end-to-end, global multi-asset trading solution with these attributes, the sell-side can prepare for tomorrow's regulatory challenges and market structure changes, protect assets, and succeed in a dynamic economic environment.

CONCLUSION

The trading landscape has certainly changed in the past ten years. Regulatory oversight, trade volume fluctuations, increased market data, decreasing margins and rising costs are placing added pressure on buy-side traders. At the same time, the buy-side is striving to access an ever-increasing number of execution venues to trade an expanding array of global, multi-asset in a fragmented market. The sell-side can play an important role in helping the buy-side navigate this new, complex trading environment by offering value-added services that allow the buy-side to focus on what it does best — seeking alpha for its investors.

Savvy sell-side firms will gain a competitive edge by embracing technologies that allow them to stay ahead of regulatory changes and changing market conditions, and provide access to global, multi-asset trading. A sell-side firm that can provide these services in an integrated manner, addressing the entire trade lifecycle while offering both low-touch and high-touch trading options, will most certainly be able to endure any changes in trading environments.

By working with a strategic technology partner, sell-side firms can explore new revenue opportunities, enhance execution quality and capabilities, and seek reductions in access and clearing costs associated with participating in a deeply fragmented marketplace. Meanwhile, fluctuating volumes will continue to significantly impact firms' profitability. The right technology partner with an end-to-end trading architecture is in the unique position to provide sell-side firms with an innovative and cost-effective trading technology solution that will meet their evolving needs.

ABOUT SUNGARD

SunGard is one of the world's leading software and technology services companies. SunGard has more than 20,000 employees and serves 25,000 customers in 70 countries. SunGard provides software and processing solutions for financial services, higher education and the public sector. SunGard also provides disaster recovery services, managed IT services, information availability consulting services and business continuity management software. With annual revenue exceeding $5 billion, SunGard is ranked 435 on the Fortune 500 and is the largest privately held business software and IT services company.

ABOUT VALDI

SunGard's Valdi provides equities, futures, fixed income and options traders with multi-asset, front-to-back trading and risk management solutions on 110 markets worldwide. SunGard's Valdi global trading solutions support the entire trade lifecycle including integrated trade and order management systems, execution services, risk management, compliance, professional trading and clearing and settlement services. With global connectivity via SunGard's global network, SunGard's global trading solutions are engineered to help customers achieve increased performance, low latency and execution across multiple platforms, instruments and geographies.

FOOTNOTES

1 WJB Delivers Best Execution in Partnership with its Customers. TITLE A Supplement to Traders Magazine. DATA

2 Shahrawat, Dushyant; Butterfield, William; Bruel, Stephen. The Changing Electronic Trading Landscape: Assessing the Drivers for 2010 and Beyond. Tower Group. January 18, 2010.

3 Ibid.

4 High Frequency Trading Technology: A TABB Anthology. TABB Group. August 2009.

5 Nelson, Stephen J. Commentary: The Changing Role of the Broker-Dealer in an Electronic Universe. Traders Magazine Online News, January 19, 2010.

6 Shahrawat, Dushyant; Butterfield, William; Bruel, Stephen. The Changing Electronic Trading Landscape: Assessing the Drivers for 2010 and Beyond. Tower Group. January 18, 2010.

7 Crossing Networks/Dark Pools. Traders Magazine Supplement. April 7, 2009.

8 SEC Issues Proposals to Shed Greater Light on Dark Pools, SEC. October 21, 2009. http://sec.gov/news/press/2009/2009-223.htm.

9 Crossing Networks/Dark Pools. Traders Magazine Supplement. April 7, 2009.

10 Ibid.

11 Shahrawat, Dushyant; Butterfield, William; Bruel, Stephen. The Changing Electronic Trading Landscape: Assessing the Drivers for 2010 and Beyond. January 18, 2010.

12 Lee, Sang. New World Order: The High Frequency Trading Community and Its Impact on Market Structure. Aite Group. February 25, 2009.

13 Iati, Robert. Buy-Side Clearing: Driving Efficiency Through Aggregation. TABB Group. September 4, 2007.

14 Kanter, Blair. EMS vs. OMS Revisited: What Should the Buyside Do? Advanced Trading. June 18, 2009.

15 Shahrawat, Dushyant; Butterfield, William; Bruel, Stephen. The Changing Electronic Trading Landscape: Assessing the Drivers for 2010 and Beyond. January 18, 2010.

16 High Frequency Trading: A TABB Anthology. TABB Group. August 2009.

17 Kentouris, Chris. Dear CEOs: Get More Data for Risk Analysis. Securities Industry News Blog. January 19, 2010.

18 Guerrera, Francesco Guerrera, Henny Sender and Aline van Duyn, Ailing Securitisation Market Hits Citi Asset Sales. Financial Times, February 7, 2010, http://www.ft.com/cms/s/0/1f812892-143c-11df-8847-00144feab49a.html

19 Honoré, Adam. Market Data Infrastructure Challenges Aite Group. April 22, 2009.

20 McPartland, Kevin. OMS or EMS? The Buyside Perspective on Selection and Convergence. TABB Group. January 12, 2009.

21 Shahrawat, Dushyant. The Changing Electronic Landscape: Assessing the drivers for 2010 and Beyond. TowerGroup. January 2010

22 McEachern Gibbs, Cristina. Buyside Algo Usage, Block Trading on the Rise: TABB Report. Advanced Trading. February 4, 2010.

23 Sussman, Adam; Shultz, Monica. Searching for the Sell-Side: An Added Value to High-Touch Trading. TABB Group. February 6, 2008.

www.sungard.com/valdi

SunGard

545 Washington Blvd.
7th Floor
Jersey City, NJ 07310
Tel: 201-499-5900

General Inquiries:
trading-info@sungard.com