



# Wall Street Technology

## Going Direct

Aug 27, 2004

URL: <http://www.wallstreetandtech.com/showArticle.jhtml?articleID=42700083>

The wave of consolidation hitting the direct-market access (DMA) technology sector hammers home just how important the space has become for Wall Street and the impact it can have on institutional relationships with buy-side firms. It's also prompting new players to step into the market.

According to Jodi Burns, an analyst with Celent Communications, "We're seeing a lot of acquisitions of the direct-access firms by the broker-dealers." She explains that the trend is a response to the adoption of direct-access technology by buy-side firms. "Sell-side firms are asking, How can I deepen my relationship with my buy-side customers?" One way to do that is to offer the buy side a direct-access platform, she says.

The acquisitions are raising concerns in the industry, however, that broker neutrality - a feature that many of the direct-access firms used as a sales enticement - has been tossed out the window. The consolidation also raises the specter of leakage of trading information and questions about whether firms can expect to get best execution when exercising their trades.

## Survival of the Fittest

In early July, Citigroup's corporate and investment banking group acted on its resolve to get more involved in the execution side of the business by scooping up Lava Trading, the 800-pound gorilla in the direct-access market. Though figures were not disclosed, estimates place the price tag at more than \$500 million. Citigroup says Lava will operate as an independent subsidiary; Lava's CEO, Richard Korhammer, will report to James Forese, managing director and head of Citigroup Global Equities.

That followed a March deal in which Bank of New York Securities acquired direct-access provider Sonic Financial Technologies. The bank says the deal allows BNY Securities Group to provide broker-dealers and institutional investors with enhanced smart order routing and improved direct-access trading to all major equity markets, including the New York Stock Exchange and other exchanges, Nasdaq, and alternative-trading systems. Shortly after the purchase, BNY launched DEX, short for direct execution services, a suite of direct-market access trading solutions that helps institutional investors manage their trading and execution strategies.

And one of the first out of the acquisition block was Bank of America, which acquired Direct Access Financial of Dallas, a provider of direct-access trading technology to the institutional brokerage and

investor community, in February. Direct Access Financial, which became an operating unit of Banc of America Securities' global equities group and part of its electronic trading services unit, is charged with developing technologies to lower trading costs and improve institutional clients' ability to manage equity flows.

Andrew Fishman, president of the Schonfeld Group, which has 500 proprietary traders that oversee \$600 million in investments, says, "The acquisition binge under way is an admission by Wall Street that it wasn't paying much attention to direct access and the development of the technology associated with it." Fishman's firm specializes in short-term trading and recently launched Schonfeld Institutional Brokerage Services, a joint venture with direct-access provider Trinitix Securities.

Despite the consolidation, according to Larry Tabb, of The Tabb Group, "There's an opportunity for new players to come into the market that are broker-neutral."

"Broker neutrality is still an important aspect to direct access," Celent's Burns says. "I think the buy side is not interested in wedding themselves to any one particular broker. They like the idea of forcing the brokers to compete for their business."

Burns asserts that Lava has a challenge on its hands now that Citigroup has acquired it. "They need to create a sense of independence, or it will hurt Lava," she says, quickly adding, "It's possible to run an independent subsidiary." Disclosing how they've restricted communications across the companies in Citigroup's public filings "can really go a long way toward convincing customers that Lava is independent," she continues.

But Richard Korhammer, CEO of Lava, thinks concerns about his firm's independence are overblown. "It's business as usual. We are independent," he says. "We expect to maintain all the confidentiality we have in the past. People are looking for technology to help them get a great price. Ultimately, the buy-side traders are no different than the sell side - they want to take matters into their own hands and trade."

That's exactly what the buy side seems to be doing. Automated or program trading accounted for almost 60 percent of the volume on the NYSE in early July. And, according to Larry Tabb, more than 47 percent of buy-side firms have some type of connectivity to direct-market access.

### **Liquidity, Cost and Speed**

One of the biggest drivers of direct-market access adoption is fragmented liquidity. Liquidity is spread across different pools; direct-market access technology provides an integrated view of that fragmented market, Tabb says.

But liquidity and DMA technology go together for another reason. Mike Plunkett, president of Instinet's North American division, says DMA is growing more important for trading strategies, especially for those stocks that are highly liquid. Rather than routing those orders through a broker for execution, he says, buy-side firms can do it themselves. "Direct-market access is becoming more and more the primary choice for the buy side. It's a more cost-effective way of executing," he explains.

Tabb says that the need for faster executions is driving firms into the DMA camp. "The market is speeding up," he observes, and the buy side needs to keep up to compete.

The number of brokers that a buy-side firm uses is declining, Tabb continues. But firms still average between 28 and 52 brokers, depending on the buy-side firm's size. So expect to see DMA platforms

offer more multi-broker functionality, he says.

Carey Pack, president of BNY Brokerage, which purchased Sonic, says that's one of the things his firm is considering. "We want to be able to allow our clients to use the platform in a multi-broker fashion." His firm's integration of Sonic's direct-access platform with BNY trading tools through the launch of DEx is the start of that and a reflection of the trend to provide buy-side firms with more control, he says. "Buy-side clients want more control over trading and order flow and anonymity. They want to make sure their orders aren't conflicted and the information doesn't leak and cause them harm in terms of performance."

FlexTrade Systems of Great Neck, N. Y., is touting its FlexDMA offering - a comprehensive array of direct market access servers - to sell-side firms as a means for the sell side to provide better services to buy-side institutions. FlexDMA provides configurable internal and external routing, comprehensive pre- and post-trade analysis and smart order routing.

### **Go to the Head of the (Asset) Class**

As DMA adoption increases, DMA technology is expanding well beyond the equity markets into other asset classes. Celent's Burns says buy-side firms "want to trade multiple assets classes in one platform." As a result, technology vendors are building DMA connections to options, futures, foreign exchange and fixed income markets.

For example, Lava's Korhammer says his firm plans to launch a foreign-exchange platform to complement its equities offering. "We anticipate over time entering into new security classes," he notes.

Regulatory issues also may drive the growth of DMA. Soft dollars are under attack, and some fund companies have done away with them, notes David Sher, senior managing director at Electronic Specialist, an institutional brokerage that provides direct-access and trading solutions to broker-dealers and institutional investors. Firms are demanding that pricing be unbundled so they know how much they are paying for research. Additionally, the fair disclosure rule, which requires equal distribution of research, has lowered the value of research, Sher says. Once firms better understand their execution and research costs, direct-market access will be more attractive, he predicts.

Furthermore, Regulation NMS is likely to spark DMA growth as exchanges race to become fast markets and offer automated quotes and executions. Reg NMS seeks to establish a uniform trade-through rule for all market centers, affirming that price priority is fundamental. It would also establish a uniform market-access rule to help ensure non-discriminatory access to the best prices displayed by market centers.

Instinet's Plunkett says the NYSE could be a catalyst to adoption of DMA. "If the NYSE was to get up to speed with the rest of the community and have automated executions, you would see that market change over night."

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### **What Is Direct Market Access?**

Like many phrases in the investment industry, direct market access has been used, abused and twisted to suit the needs of vendors and brokers looking to plug their services. In its simplest form, direct market access is best described as technology that allows buy- or sell-side firms to route orders directly to all market destinations and pools of liquidity.

What direct market access isn't, critics say, is an agency brokerage that works trades for clients. Rather, direct-market access eliminates the middleman and features automatic order routing that sends the trade to the destination of choice without going through a desk or matching service.

### **Who is doing it?**

The adoption rate of direct-market-access technology is being driven by the larger firms, says Jodi Burns, an analyst at Celent Communications in Boston. Small institutional firms are bringing up the rear when it comes to adoption, she says, because "they are in less of a position to spend money on that type of technology."

DMA technology, however, is also finding its way into prime broker offerings, notes Scott Kurland, senior managing director at Electronic Specialist, an institutional brokerage that provides direct access and trading solutions to broker-dealers and institutional investors. Prime brokers are providing their buy-side clients with tools for direct access and connectivity.

### **Why is DMA technology important for the buy side?**

Larry Tabb, founder of The Tabb Group, says, "DMA technology is important because it really creates a unified order book." It takes a fragmented marketplace and "brings it together in one place. It is very difficult without DMA technology to look at all the open orders."

DMA technology also provides the buy side with more independence and control of its order flow, says Burns, adding, "Buy-side firms are facing cost pressures and looking to take on more trading so they can manage those transaction costs and minimize the information leakage."



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